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S&P backs down from ESG scores critics called 'confusing'

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S&P Global Ratings' announcement it will not release new or updated environmental, social, and governance credit indicators in public finance comes amid confusion over their impact on bond ratings, as well as an anti-ESG backlash that produced a deluge of legislation this year to stop the factors' encroachment in government activities.

The rating agency called its decision independent and analytical, noting its reports will continue to address ESG credit factors.

"We determined that the dedicated analytical narrative paragraphs in our credit rating reports are most effective at providing detail and transparency on ESG credit factors material to our rating analysis, and these will remain integral to our reports," S&P said in a statement.

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"I do think it means the headwinds facing ESG in the muni market — tremendous variation in ESG risk exposures across issuers, no shared concept of materiality, and, indeed, outspoken and politically influential anti-ESG forces — are forcing S&P to take a pause," he said.

Public finance attorney Neal Pandozzi, a partner at Bowditch & Dewey, said S&P's move "arguably eliminates any appearance of an ESG ranking system, where ESG scores alone could be misconstrued as directly influencing rating decisions, independent of the total mix of available information relevant to an issuer's creditworthiness."

For investors, it means continuing to do their homework.

Dan Solender, director of tax free fixed income at Lord Abbett, said while S&P reports may be reviewed, the asset management firm does its own proprietary research analysis "in reviewing all important inputs to our investment decisions and that won't change."

Howard Cure, director of municipal bond research at Evercore Wealth Management, said S&P's ESG indicators sowed confusion and controversy.

"As a rating agency, you do not want to be part of this debate, but should prefer to operate in the background as a service to investors," he said, adding "it will remain up to the investor to assess and weigh ESG criteria and risks in determining the appropriate yield for their investments."

Cure added while environmental factors are increasingly weighing on state and local governments and will further strain their finances via additional capital outlays, social and governance risks are more ambiguous and have not been consistently applied.

S&P's March 2022 release of state and territory ESG indicators, which were largely neutral, drew sharp criticism from Republican officials and made S&P a target of an ongoing multi-state probe launched last September.

The alphanumeric indicators, ranging from one to five, tipped to moderately negative or negative for red and blue states alike, accounting for 25% of the sector due to environmental factors such as risks posed by hurricanes, wildfires, drought, and sea-level rise, 20% for social factors like weak demographics, and 12% for governance.

Utah Treasurer Marlo Oaks, a vocal critic of the indicators, which included a moderately negative environmental factor for the state due to its water supply challenges, said he hoped the announcement is a step towards "depoliticizing the ratings process."

"If a factor is truly financially material, it belongs in the credit rating where it has always been, not called out in a separate political score," he said.

Oaks, a Republican, joined with other top elected officials in the state last year to demand S&P stop applying ESG factors to Utah's triple-A rating through the use of what they called a politicized rating system based on indeterminate factors. S&P declined to comply, saying "we will not allow any issuer to inappropriately influence our analytical processes or our credit rating opinions."

Texas Comptroller Glenn Hegar called the indicators "opaque and often irrelevant to an entity's creditworthiness."

"However, I remain cautious as to this announcement, as S&P plans to use ESG factors in their rating analysis and will remain as part of their reports," he said. "While I recognize that G stands for governance, which has long been the foundation of creditworthiness, the other components of ESG remain vague, undefined, and confusing to be a meaningful part of a credit rating."

West Virginia State Treasurer Riley Moore, another critic, called S&P's move a clear victory in a fight to stop ESG.

"This ratings scheme was poised to be the first step in a slippery slope toward placing ESG scores on all citizens, threatening their financial security if they did not fall in line with the woke agenda," he said in a statement. "The fact that S&P Global has stepped back provides hope for a return to financial sanity in America."

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A sweeping anti-ESG law enacted this year in Florida prohibits issuers in the state from using a rating agency if an ESG score negatively impacts their bond ratings.

Ben Watkins, director of the state's division of bond finance, said S&P's decision is a welcome change and a recognition that risk assessment and credit analysis cannot be simplified to a number.

"I think it was way oversimplified and misunderstood about what it was and what it wasn't," he said, adding he hoped other rating agencies would dispense with ESG scores.

Fitch Ratings and Moody's Investors Service have scoring systems and there is no indication either is poised to follow S&P's lead.

"Moody's incorporates all risks, including those related to ESG, into its credit ratings when they are material, and also publishes ESG scores on a 1 to 5 scale," the rating agency said in a statement.

Fitch Ratings highlights through its ESG Relevance Scores whether and how an ESG issue affects a bond issuer's credit rating, a spokesperson for the rating agency said.

"The ESG relevance scores for the rated portfolio indicate that ESG risks generally have a low level of direct impact on U.S. public finance and infrastructure credit ratings," the spokesperson said.

Kroll Bond Rating Agency, on the other hand, eschewed ESG scores.

"We decided early on after a lot of market outreach, a lot of discussion with investors, that the best way for us to make a valuable contribution in the marketplace was to comment on the subset of ESG factors that impact a credit risk analysis or specifically the risk of default," said Patrick Welch, KBRA's chief ESG and ratings policy officer.

S&P's move "is a recognition that's what the marketplace wants from a credit rating agency and that's what we've done from the beginning," he added.

Last September, then-Missouri Attorney General Eric Schmitt launched a probe into S&P's use of ESG factors in public finance ratings that eventually included his counterparts in Utah, Kentucky, and Texas.

Andrew Bailey, who took office as Missouri attorney general in January, said he applauded "S&P's decision to heed our warning and follow the law by putting its shareholders' financial interests before a political agenda."

Meanwhile, there was a big anti-ESG legislative push this year. Pleiades Strategy reported in June that 165 measures were introduced in 37 states with at least 22 laws and 6 resolutions in 16 states passing.

Some were expanded versions of a 2021 Texas law that punishes firms determined to be boycotting the fossil fuel industry through the divestment of government funds and a ban on bond underwriting and other contracts with the state and local governments. The conservative Heritage Foundation offered model legislation on its website that included a laundry list of prohibited "boycotts."

The U.S. Supreme Court may have opened the door for these kinds of bills when it declined in February to take up a challenge to an Arkansas law involving boycotts of Israel.

A study last year found Texas laws banning contracts with fossil fuel boycotters and companies that discriminate against the firearm industry may increase borrowing costs for issuers in the state as a result of less competition among underwriters. The laws initially sidelined some big investment banks from the Texas muni market and resulted in outright bans for Citigroup and UBS, while Wells Fargo's status is currently under review.

Wells Fargo, along with JP Morgan Chase and Bank of America were banned from deals in Oklahoma earlier this year under a similar anti-boycott law passed by state lawmakers in 2022.

A first-of-its-kind ESG disclosure rule that took effect July 30 in Missouri is being challenged in federal court by the Securities Industry and Financial Markets Association, which contends the rule conflicts with the uniformity objective of federal securities laws.

Missouri Secretary of State Jay Ashcroft defended the rule, saying it was aimed at protecting investors "from those who disguise the truth."

"The rule implements client disclosure standards pertaining to security investments and how investment advisors and broker-dealers disclose investment strategies that propagate values-based agendas that are not purely focused on generating profit for their clients," he said in a statement.