

**Louvain School of Management
and Prague University of Economics and Business**

ESG factors integration into corporate credit ratings: examining the current state and its possibilities of improvement following the CSRD

Based on expectations within the EU

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The 14th of August, 2024,

Marion Lernoux



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Abstract

This thesis explores the impact of the Corporate Sustainability Reporting Directive (CSRD) on the integration of Environmental, Social, and Governance (ESG) factors into corporate credit ratings within the EU. Through interviews with key stakeholders, the study evaluates how EU-registered credit rating agencies (CRAs) assess the creditworthiness of EU-based companies, and explores the anticipated CSRD's effect on non-financial information and corporate credit ratings.

The findings reveal that ESG integration into corporate credit ratings across EU remains superficial, characterized by an undefined and subjective approach where ESG factors are often treated as secondary considerations that rarely influence final ratings. The primary obstacles include the lack of sufficient quality and comparability of non-financial information, particularly for smaller companies, along with a lack of tools and expertise to accurately assess their impact.

Despite short-term uncertainties and compliances challenges, the CSRD is expected to achieve its long-term goals, by significantly improving the quality, availability, and comparability of ESG information, thereby addressing existing challenges in ESG incorporation for EU-registered CRAs. This enhanced reporting environment is expected to transform the quality of corporate credit ratings in the EU, significantly deepening ESG integration into credit analysis, and decision-making processes.

Keywords: Credit rating agencies; corporate credit ratings; ESG integration; Corporate Sustainability Reporting Directive

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List of abbreviations

CRA – Credit Rating Agency

CSR – Corporate Social Responsibility

CSRD – Corporate Sustainability Reporting Directive

EC – European Commission

EFRAG – European Financial Reporting Advisory Group

ESG – Environmental, Social, and Governance

ESMA – European Securities and Markets Authority

ESRS – European Sustainability Reporting Standards

EU – European Union

GSIA – Global Sustainable Investment Alliance

IMF – International Monetary Fund

NFRD – Non-Financial Reporting Directive

PIE – Public Interest Entities

PRI – Principle for Responsible Investment

SF – Sustainable Finance

SRA – Sustainable Rating Agency

UN – United Nations

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INTRODUCTION

1. Context

“ESG factors are increasingly recognized as material to risk assessment and value creation, and dismissing them can lead to mispriced risks and missed opportunities. Investors who ignore ESG issues are voluntarily putting a blindfold on themselves.”

Peter Walsh, director of ESG market strategy
& partnership at Benchmark Gensuite¹

This statement by Peter Walsh highlights the increasing significance of Environmental, Social and Governance (ESG) considerations in contemporary financial market practices and decision-making.

Indeed, ESG integration is no longer optional - the train has already left the station. In 2022 alone, global sustainable investing assets reached \$30.3 trillion (Global Sustainable Investment Alliance, 2022). In 2023, sustainable funds outperformed traditional funds across fixed-income asset and equity classes (Iyer, 2024). And looking ahead, assets managed by ESG mutual funds in the European Union (EU) are projected to reach a historic peak of 7.6 trillion euros by 2025 (CSB Global Conference, 2023). Now more than ever, the financial market is viewing ESG performance as indicative of long-term corporate health and effective risk management.

On their side, credit rating agencies (CRAs) are also incorporating ESG factors into their credit risk evaluations. Major CRAs such as S&P Global Ratings, Moody's and Fitch Ratings have recognized that such considerations can also significantly influence a company's risk profile and financial outlook. However, the integration of these factors remains a challenging endeavor, with CRAs facing difficulties in developing consistent and robust methodologies that effectively capture these complexities (Cash, 2021). Despite these efforts, it appears that investors are not satisfied by the level of ESG integration (Principles for Responsible Investment [PRI], 2017). And it seems indeed that it is not enough: in early April 2024, the authority entity supervising CRAs in the European Union (ESMA) initiated a new consultation on proposed amendments to the current CRA regulatory framework to enhance ESG integration into their methodologies and transparency (ESMA, 2024).

¹ Quote taken from the following interview: Kenway, N. (2024, June 20). *Is ESG making a comeback or has it only just truly arrived?* Future portfolio adviser. <https://future.portfolio-adviser.com/is-esg-making-a-comeback-or-has-it-only-just-truly-arrived/>

Simultaneously, the European Commission (EC) has launched a new corporate sustainability directive, the Corporate Sustainability Reporting Directive (CSRD), designed to address the shortcomings of the previous one (the Non-Financial Reporting Directive). Starting with certain companies in the financial year 2024, the CSRD will gradually broaden its scope from 11,000 to 50,000 entities, including non-EU companies. With the implementation of common and stricter standards, the directive aims to foster sustainable practices among corporations, by enhancing transparency around sustainability issues and improving both the quality and comparability of the non-financial information they disclose (McGarry et al., 2022).

2. Research question & objectives

As the integration of ESG factors seems to remain a challenge for credit rating agencies, and with the CSRD aiming to enhance sustainable information and data in the EU corporate sphere, we could naturally ask ourselves whether the CSRD could influence the incorporation of ESG considerations when evaluating the creditworthiness of EU companies.

Within this context, this paper seeks to address the following question: **“How can the introduction of the CSRD facilitate the integration of ESG factors into corporate credit ratings within the EU?”**

Throughout the following pages, our objectives are threefold: 1° to examine the CSRD’s impact on EU non-financial information; 2° to assess the current state of ESG integration into credit risk assessments of EU companies and; 3° to explore the opportunities that the CSRD may present for facilitating the integration of ESG factors into EU corporate credit assessments.

3. Thesis structure

Aiming to address the research question, the existing literature will first be reviewed, introducing the ESG integration concept, corporate sustainability reporting requirements, as well as CRAs and their current ESG integration into corporate credit ratings. Following this, the methodology will detail the justifications behind the chosen qualitative approach and go over interview guides construction, participants selection, and analysis method. Results from the interviews will be summarized, followed by a comparative discussion of these findings with the existing literature. Ultimately, the paper will conclude by presenting its main contributions, conclusions and a discussion of any limitations and future research directions. References will be included at the end of the paper. For additional context and details, appendices containing interviewee and company profiles, interview guides and transcripts will be provided in a separate document.

LITERATURE REVIEW

1. Sustainability in finance

1.1 Introduction to sustainable finance

As defined by the European Commission (EC) (n.d.-c), sustainable finance (SF) is “the process of taking environmental, social and governance (ESG) considerations into account when making investment decisions in the financial sector, leading to more long-term investments in sustainable economic activities and projects”. Its roots trace back to the 1992 Earth Summit's United Nation Environmental Programme Finance Initiative (UNEP, 2017), and even earlier with UK church investors in 1948 and Catholic Church's ethical practices (Russel Sparkes (2003) as discussed by Cash (2018a)).

The concept gained momentum through sustainability awareness in the 1970s, spurred by the Club of Rome's report on the Earth's limited capacity for unchecked economic growth, and further emphasized by the United Nation's (UN) Brundtland report in 1987 (Schoenmaker & Schramade, 2019). The development of Corporate Social Responsibility (CSR) in the 1980s and 1990s highlighted business roles in sustainability issues (Soppe, 2009). The SF evolution mirrors the financial industry's shift towards responsible investment practices (Schoenmaker & Schramade, 2019), a trend significantly underscored by the 2008 Financial Crisis (Cash, 2021). SF is now considered crucial for the EC, in supporting economic growth and environmental goals, and plays a key role in the European Green Deal, aiming for EU climate neutrality by 2050 (EC, n.d.-c).

1.2 ESG factors in finance

The shift towards SF is heavily supported by the Environmental, Social and Governance (ESG) factors. According to Moody's (2023), ESG encompasses a wide range of qualitative and quantitative considerations related to the sustainability of an organization, and the impact of its operations, investments and businesses on society and environment. It is widely argued that these issues should be carefully examined when making financial decisions (Cash, 2021).

ESG integration involves the “the systematic and explicit inclusion by investment managers of environmental, social and governance factors into traditional financial analysis” (PRI, 2017, p.39), the reference to traditional finance underscoring its primary goal of optimizing risk-adjusted returns (Schoenmaker & Schramade, 2019). This integration can take qualitative forms, where ESG issues are subjectively analyzed and included in organizations or

investments' assessments, or quantitative forms where ESG statistical data is incorporated into financial models (Cash, 2021). The latter, while favored for its precision and objectivity, is hindered by the poor quality of available ESG data. Indeed, the large and diverse available volume of ESG data has caused poor data quality, related to its materiality, accuracy, reliability and comparability (Jonsdottir et al., 2022; Rogge & Ohnesorge, 2022), leading to concerns among investors.

Despite notable challenges, ESG integration is widely recognized as a key approach to responsible investment and its mainstream adoption (Cash, 2021). A 2020 study of the Global Sustainable Investment Alliance (Figure 1) demonstrated its significant rise as a sustainable investment strategy, showing a growth reaching 143% between 2016 and 2020. The popularity of ESG factors themselves, now deemed relevant for financial world (Cioli et al., 2023; Dell'Erba & Doronzo, 2023), has driven demand from investors and financial actors for ESG information (Fitch Ratings, 2021). This growth trajectory is expected to continue, with assets managed by ESG mutual funds in the EU forecasted to reach a historic peak of 7.6 trillion euros by 2025 (CSB Global Conference, 2023). According to Sarkar (2022) from Deloitte, these three factors are now considered as pillars for assessing an organization's commitment and progress towards sustainability and climate change objectives.

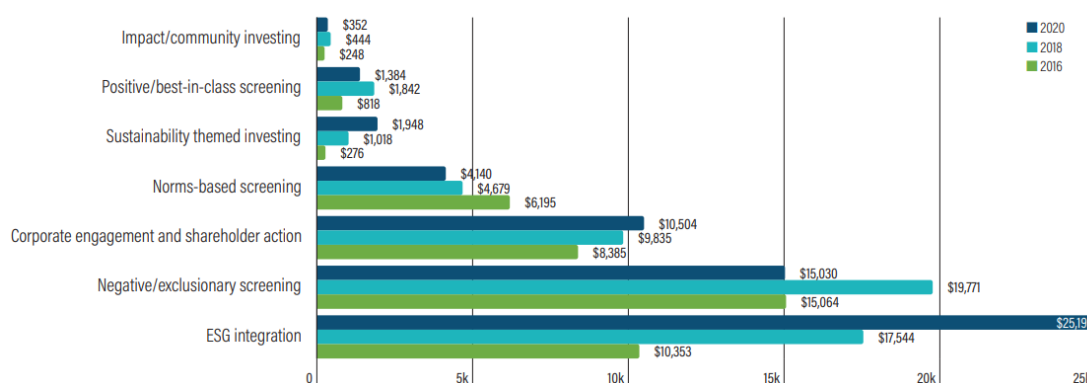


Figure 1 – Sustainable investment assets by strategies, 2016-2020, in USD dollars (GSIA, 2020)

Such an outcome has not arisen without reason. This is attributed to numerous inadequately managed ESG-related instances, such as the 2008 Financial Crisis, various scandals involving poor working conditions, and the clear manifestation of climate change and its negative effects (Billio et al., 2022). Given these ESG-related issues and their potential impact on investments, current investors are now demanding higher quality information that includes ESG factors (Cash, 2021). Several other factors are highlighted by Cash (2021) that further drive the ESG integration's adoption. First, an increase in millennial and female investors, who tend to prioritize more societal issues to align their investments with their values. Second, the

increasing evidence of a positive relationship between ESG ratings and market value. And last, a growing support from diverse multi-stakeholder initiatives advocating for more general sustainable finance practices.

1.3 Corporate Sustainability Reporting Directive

Amending the Non-Financial Reporting Directive

In recent years, ESG considerations have emerged as crucial in shaping corporate behavior and investor decisions globally. As awareness of sustainable issues has grown, so has the demand for robust non-financial data. To promote sustainable practices and support the EU's sustainability goals, regulatory bodies have started implementing frameworks to standardize ESG reporting and disclosure. One such regulation gaining significant traction is the Corporate Sustainability Reporting Directive (CSRD).

Since the fiscal year 2017, the Non-Financial Reporting Directive (NFRD) has been setting the stage for fostering corporate sustainable reporting within the EU. It mandated large public interest entities² (PIE hereafter) with more than 500 employees to disclose information about “environmental matters, social an employee-related matters, respect for human rights, anti-corruption and bribery matters” (Directive 2014/95/EU, recital 6). This directive intended to increase the “consistency and comparability of non-financial information disclosed throughout the Union” (Directive 2014/95/EU, recital 6), thereby promoting CSR activities among the targeted companies (Fiechter et al., 2022).

Notwithstanding, it has been claimed that the information disclosed under NFRD is insufficient as companies often omitted information considered essential by stakeholders. Another critical issue lied in the lack of comparability between reports, as companies had the choice of reporting standards. Additionally, the lack of quality and related trustworthiness has convinced the European Commission to propose a new directive, the Corporate Sustainability Reporting Directive (EC, 2021; Fiechter et al., 2022). Looking ahead to the financial year 2024, the CSRD is set up to amend the NFRD.

A bigger step towards sustainable information disclosure

The Corporate Sustainability Reporting Directive (CSRD), proposed by the EC in April 2021, and voted on in November 2022, has been in effect since the 5th of January 2023 (McGarry et al., 2022). It aims to build upon the NFRD by further supporting the transition to a sustainable

² Public Interest Entities (PIE): EU companies that are either 1° listed on a regulated EU market; 2° a specific form of financial services company, as insurance company or credit institution (listed or not); 3° have been designated as such by national authorities (Davies et al., 2023).

economy. The initiative aligns with the objectives outlined in the Paris Climate Agreement and the EU Green Deal (Verheijke & Anema, 2022), while harmoniously integrating existing EU sustainability framework and regulations such as the EU Taxonomy and the Sustainable Finance Disclosure Regulation (SustainLab, 2023).

A primary objective of the CSRD is to significantly broaden its scope, by gradually encompassing a larger number of companies over several phases in the upcoming years. While the NFRD covered 11,700 companies, the CSRD will eventually require 50,000 companies to report on sustainable disclosures upon the completion of all phases, as detailed by McGarry et al. (2022). Notably, over 10,000 of these entities are based outside of the EU, with approximately one-third situated in the United States according to a recent analysis by Refinitiv (LSEG, 2023). Table 1 delineates each phase and identifies the companies that will be subject to CSRD reporting requirements.

Financial Year (publishing year)	CSRD Targeted Companies ³
Jan. 1 st , 2024 (2025)	Companies already required to report under the NFRD: EU large undertaking firms and EU parent entities of large groups, who are PIE and with > 500 employees on average
Jan. 1 st , 2025 (2026)	Other large companies not covered by the NFRD: all large EU entities, listed and non-listed, and EU parents entities of large groups included, satisfying at least two of the following criteria: <ul style="list-style-type: none"> • > 250 employees on average • > 50M € of net turnover • > 25M € total balance sheet
Jan. 1 st , 2026 (2027) Possibility to opt-out until FY 2028	SMEs listed on an EU-regulated markets , excluding micro-undertakings, meeting at least two of the following criteria: <ul style="list-style-type: none"> • > 50 employees on average • > 10M € of net turnover • > 5M € total balance sheet + Small and non-complex credit institutions, and captive insurance undertakings
Jan. 1 st , 2028 (2029)	Third-country undertakings: Non-EU companies parents with substantial activity in the EU generating over 150M € of turnover in the EU which either: <ul style="list-style-type: none"> • Have at least one large EU-based or listed in a EU-regulated market subsidiary • Have at least one EU-based branch which itself generated > 40M € in revenue in the EU

Table 1 - CSRD phased implementation timeline: affected companies
(Compiled from Davies et al., 2023; EU Directive 2022/2464 ; Garry et al., 2022)

Additionally, the CSRD imposes more stringent requirements on the content and protocols for disclosing information (Fiechter et al., 2022). All companies under the CSRD's scope must report in accordance with the European Sustainability Reporting Standards (ESRS), which establish common standards, encompassing both qualitative and quantitative information on various ESG matters (Carabia, 2023).

³ Includes the updated size criteria for micro, small, medium-sized, and large undertakings or groups, as amended in October 2023, following inflation-based adjustments made to Directive 2013/34/EU (EC, 2023).

In April 2021, the European Financial Reporting Advising Group (EFRAG) was appointed by the EC as a technical advisor to assist in drafting these new standards. The ESRS adoption process began with a public consultation in June 2021 and received formal EC approval in November 2022 (EFRAG, n.d.). The first set of standards, officially adopted as a delegated act on the 31st of July 2023, is sector-agnostic and organized into four categories, covering two general and ten ESG areas (Branquart, 2023; Davies et al., 2023), as illustrated in Table 2. A second set of standards, delayed by two years, is expected in June 2026, focusing on sector-specific standards and those for non-EU companies (Council of the EU, 2024). Additionally, because SMEs make up 99% of European businesses (EC, n.d.-a), EFRAG is developing two separate standards for SMEs to be ready by 2026. One standard will apply to listed SMEs, as required by the CSRD, while the other will concern those choosing voluntary disclosure to support their sustainable transition (Directorate-General for Environment, 2024).

Cross-cutting standards					
ESRS 1: General principles			ESRS 2: General disclosures		
Sector-agnostic (topical) standards					
Environmental	ESRS E1 Climate change	ESRS E2 Pollution	ESRS E3 Water & marine resources	ESRS E4 Biodiversity & ecosystems	ESRS E5 Resource use & circular economy
Social	ESRS S1 Own workforce	ESRS S2 Workers in the value chain		ESRS S3 Affected communities	ESRS S4 Consumers & end-users
Governance	ESRS G1 Business Conduct				

Table 2 – Structure of the first set of ESRS (adapted from Davies et al. (2023))

Unlike the NFRD flexible obligation, where specific content requirements were not clearly defined, the CSRD ensures that companies report more precise and relevant information. For instance, companies must now disclose their plans to align their strategies and business models with the Paris Agreement's objectives, as well as its progress towards achieving sustainable goals (Directive (EU) 2022/2464). Such information must now be included in the management report, and will be reviewed to ensure limited assurance (and eventually reasonable assurance), thereby enhancing the quality and reliability of the reported data.

A significant change under the CSRD is the requirement for companies to report based on the principles of double materiality (Verheijke & Anema, 2022). Companies need to assess sustainability from two perspectives: financial materiality, which evaluates the risk material to external environmental and societal issues that impact the company's performance, and impact materiality, which considers the impact from its operations and products on the environment and society (Worldfavor, 2023). This assessment determines the scope of ESRS companies need to report on.

Another major shift introduced by the CSRD is the requirement to extend their reporting beyond their own operations to include information about their entire value chain, from clients to suppliers and partners. This ensures greater transparency and accountability across the supply chain, including for companies not directly covered, or not covered at all, by the directive (Hennaux, 2024).

Finally, it is worth noting that significant changes were made between the initial ESRS version proposed by the EFRAG, and the final version adopted by the EC. To assist companies in meeting the ESRS requirements, only the cross-cutting standards are mandatory, while topical (or sector-agnostic) ESRS are subject to the company's double materiality assessment. Additionally, phase-in requirements have been introduced, with distinctions based on company size. Companies with fewer than 750 employees have been granted additional time to comply with certain reporting obligations, acknowledging the greater challenges smaller companies may face in adapting to these new requirements. Moreover, some disclosure requirements have been made voluntary to further ease the reporting burden (Gorin, 2023; SustainLab, 2023).

2. Credit rating agencies in this landscape

2.1 Presentation of credit rating agencies

Credit ratings & credit risk

Credit rating agencies (CRAs) serve a crucial part in the financial market by providing assessments of the creditworthiness of entities, from corporations to governments (Cash, 2018a), called ratings. According to the EC, credit ratings can be defined as: "An opinion regarding the creditworthiness of an entity, a debt or financial obligation, debt security, preferred share or other financial instrument, or of an issuer ...[of such instruments], issued using an established and defined ranking system of rating categories" (Regulation (EC) 1060/2009, article 3(1)). Hence, it measures the risk that an "entity or transaction will fail to meet its financial commitments, such as interest payments and repayment of principal, on a timely basis" (Kiff et al., 2010, p.4). It hinges not only on its capacity to generate sufficient cash flow, but also on its readiness to fulfill its financial obligations on time (PRI, 2017).

Credit ratings take the form of qualitative statements (Bannier & Hirsch, 2010) and are expressed on a scale of letter (de Haan & Amtenkbrink, 2011; International Monetary Fund [IMF], 2010). These ratings are determined based on a thorough fundamental analysis of the financial and legal information provided by the security issuer (Deb et al., 2011), publicly available data (de Haan & Amtenkbrink, 2011; PRI, 2017), as well as numerous factors to

obtain the most holistic approach of the creditworthiness of an entity or transaction. Because some of the factors are difficult to quantify, they depend on the subjectivity of the credit analyst (PRI, 2017).

Ultimately, these ratings will be used in decision-making by different actors in the financial market, such as issuers, investors and regulators (de Haan & Amtenkbrink, 2011).

Roles of credit ratings agencies

According to Deb et al. (2011) and the IMF (2010), credit rating agencies have three different roles within the financial market.

The primary role of CRAs involves providing information services that mitigate information asymmetries between lenders (investors) and borrowers (issuers), as confirmed by Standard & Poor's (2012). In fact, CRAs first emerged to signal and reduce these asymmetries (Cash, 2021), addressing the issue of adverse selection, also referred to as the lemon problem (Rogge & Ohnesorge, 2022). This problem arises because investors typically lack the extensive information that issuers possess regarding the creditworthiness of potential investors. Gathering such information would be both costly and time-consuming for investors (Deb et al., 2011; de Haan & Amtenkbrink, 2011; IMF, 2010). Therefore, CRAs act as intermediaries or gatekeepers (Dell'Erba & Doronzo, 2023), leveraging their expertise and unique position to acquire and disseminate credit risk information more efficiently, thereby helping investors assess the relative credit risk of different investments.

On the other hand, CRAs also provide monitoring services to further reduce information asymmetries. CRAs continuously assess issuers' ability to repay investments, offering investors ongoing oversight (Deb et al., 2011). This monitoring is supplemented by the disclosure of outlooks and rating reviews, the latter often referred to as "watchlists". Whereas outlooks offer insight into the medium-term trajectory of a credit rating, watchlists focus on shorter-term developments, typically within a three-month horizon (Bannier & Hirsch, 2010; de Haan & Amtenkbrink, 2011). These assessments can lead to potential downgrades, upgrades, or confirmations of the initial rating. Consequently, these monitoring mechanisms exert pressure on reviewed issuers by signaling the possibility of rating deteriorations. This implicit contract encourages issuers to undertake corrective measures to avoid downgrades (Bannier & Hirsch, 2010; de Haan & Amtenkbrink, 2011). The pressure from CRAs is particularly acute for lower-quality borrowers (Bannier & Hirsch, 2010).

Through these two primary functions, CRAs contribute to improving market efficiency by reducing the information gap between borrowers and lenders, and by monitoring credit risk's changes. This helps ensure an even playing field among investors by minimizing the advantage one might gain through superior judgement of credit worthiness (Standard & Poor's, 2012).

Finally, the literature highlights the certification role of CRAs, also referred to as the regulatory role (Rogge & Ohnesorge, 2022). As credit ratings have become widely accepted and trusted in financial markets, regulators have increasingly relied on them for prudential oversight. The reliance is now so widespread that almost all financial regulators, including public authorities overseeing various types of financial institutions (banks, insurance companies, mutual funds, and similar entities), used them as a key tool in their regulatory work (Cantor & Packer, 1994). According to Deb et al. (2010), credit ratings are now also "hardwired" into contractual terms and market practices. They are essential for assessing capital markets, attracting investments, and meeting collateral requirements. By setting thresholds for market entry and determining favorable funding conditions, credit ratings certify an entity's financial stability, thereby influencing its market opportunities and obligations.

Given the significant market impact and reliance on credit ratings, their accuracy is crucial. Ratings must accurately reflect the credit risk and financial health of entities they assess. The Asian crisis of 1997-1998, the collapse of Enron in 2001, the Financial Crisis of 2008, and the subsequent European sovereign debt crisis, starkly illustrate the profound influence of credit ratings on global markets. These events underscore the pivotal role of CRAs and their responsibility to ensure the accuracy and reliability of their ratings (Cash, 2021; Debt et al., 2010; de Haan & Amtenkbrink, 2011). Consequently, concerns about the ability of CRAs to effectively manage this critical responsibility have arisen repeatedly.

Overview of the market & its issues

The credit rating industry is highly concentrated, with the "Big Three" – Moody's Investors Service, S&P Global Ratings, and Fitch Ratings – dominating the global market (Deb et al., 2011; White, 2010). Despite the existence of around 150 local and international CRAs worldwide, these three firms control over 96% of the global market share, and 99% of global sovereign credit ratings (Malewska, 2020). S&P and Moody's each hold approximately 40% of the market, while Fitch lags behind with less than 20%, leading to the market often being considered a duopoly with the two main leaders referred to as the "Big Two" (Malewska, 2020; de Haan & Amtenkbrink, 2011).

In the EU, their dominance is somewhat reduced, with S&P Global, Moody's and Fitch holding respectively 48.63%, 31.45%, and 10.26% of the market, as of 2023. Yet, they still overwhelmingly dominate the region, the extent depending on the type of rating (ESMA, 2023). While many CRAs are regional or product-specific, the Big Three distinguish themselves by offering a wide range of services (Deb et al., 2011; ESMA, 2023; White, 2010).

As noted by Bannier and Hirsch (2010), the use of credit ratings has experienced a significant growth, mainly driven by the globalization of financial markets and the increasing complexity of financial instruments. Not only are people more investing, but it is more difficult to do so. In this environment, investors increasingly rely on CRAs for information and services. Moreover, as mentioned in the previous section, credit ratings and their certification value have become deeply embedded in financial markets, extending beyond regulatory requirements.

In its paper, Cash (2018b) argues that the financial industry has become “addicted” to ratings, which explains why CRAs have thrived despite their role in financial crises. He attributes this to regulatory reliance concept, “the process whereby regulators incorporate credit ratings into their regulatory processes to a point whereby they essentially outsource their responsibilities to private third parties” (Cash, 2018b, p.3).

Simultaneously, despite their central role, CRAs are facing substantial criticism. Firstly, de Haan and Amtenbrink (2011) argue that historical failures, such as their involvement in several financial scandals and crises, have raised doubts about their reliability and credibility. The issuer-pay model, prevalent in the industry (Deb et al., 2010; de Haan & Amtenbrink, 2011), further compromises reliability. It creates an incentive for CRAs to potentially overrate products to maintain relationships with issuers, leading to a conflict between long-term reputation and short-term gains. This model also encourages “ratings shopping”, where CRAs might seek additional business and products to rate for higher revenues.

Inconsistencies in ratings for the same product by different CRAs, particularly present in sovereign ratings, exacerbate the issue. These discrepancies, often due to differing methodologies and subjective judgments, pose significant issues given the industry's heavy reliance on these ratings (Cantor & Packer, 1994; de Haan & Amtenbrink, 2011). However, some literature suggests that these differences, while present, may fall within an acceptable range, and could even potentially enhance the understanding of credit risk (Cantor & Packer, 1994; Deb et al., 2010).

Ultimately, the credit rating industry faces numerous challenges, including conflicts of interest and reliability issues exacerbated by its oligopolistic nature and high entry barriers. The 2008 Global Financial Crisis illustrates the profound impact of these issues on the financial industry. Regulatory measures, such as the US Dodd-Frank Act of 2010, or the EU regulatory framework of 2009, and revised in 2011 and 2013 (Malewska, 2020; PRI, 2017), are essential, as self-regulation has proven insufficient in this market, where limited competition weakens the self-disciplining role of reputation (de Haan & dAmttenbrink, 2011).

2.2 Advancing towards sustainability

We briefly mentioned the profound impact of the Financial Crisis of 2008 on the financial earlier. Cash (2021) considers the crisis as a pivotal shift that initiated a movement towards more responsible and ethical finance, away from short-term gains and blind faith in third-party credit risk verifiers. This shift marked a significant change in investors' attitude towards sustainability (Escrig-Olmedo et al., 2019), and pointed out global economic limitations (Billio et al., 2022).

ESG credit factors

ESG credit factors are “ESG factors that can materially influence the creditworthiness of a rate entity or issue and for which we have sufficient visibility and certainty to include in our credit rating analysis” (S&P Global Ratings, 2021, p.2). These factors can impact creditworthiness positively or negatively, and both directly and indirectly (Chodnicka-Jaworska, 2021). Moody's (2023) emphasizes that a comprehensive analysis of creditworthiness must include all relevant considerations, including ESG factors if they are material.

Since the crisis, and with the growing importance of ESG in investments, investors have sought to assess how ESG factors may affect their investments (Cash, 2021; Ekaterina et al., 2022). While CRAs claim to have always considered material ESG factors in their evaluations, these factors have gained prominence due to investor demands, leading CRAs to be more transparent about *how* and *when* they consider them (Cash, 2021). Both issuers and investors now seek to understand the extent to which ESG factors affect the ratings.

However, incorporating ESG credit factors into credit risk evaluation is not necessarily a move by CRAs towards sustainability. As Cash (2021) notes, this practice is more about surviving and adapting to the current wave of responsible awareness in financial markets. Nonetheless, it raises awareness among companies and financial participants about the importance of these factors in decision-making.

ESG ratings

The growing relevance of ESG issues post-crisis has made them relevant indicators of a corporation's ability to achieve sustainable strategies and practices (Cash, 2021; Dell'Erba & Doronzo, 2023). Hence, a new segment of ratings agencies, known as *sustainability* rating agencies (SRAs hereafter) or also ESG rating agencies and ESG rating providers, have emerged on the markets to rate companies on their sustainable performance (Berg et al., 2022; Escrig-Olmedo et al., 2019).

ESG ratings are regarded as “opinions and assessments about how well a company manages to balance ESG issues. It measures companies' ability to benefit from opportunities and manage risks in the mid-to long-term” (Landi and Tomo, 2017, as cited in Cash, 2021, p. 36). By assessing companies' performance on ESG criteria, SRAs encourage businesses to adopt sustainable practices.

According to the EC (n.d.-b), the importance of ESG ratings lies in its contribution to enhance transparency about companies' own impact, and to encourage sustainable investments. In addition, ESG ratings has the ambition to reduce sustainable informational asymmetry (Cash, 2021; Cioli et al., 2023; Rogge and Ohnesorge, 2022) by enhancing the transparency and disclosure of such type of information.

3. ESG integration in corporate credit ratings

3.1 Relevance of ESG factors

As soon as ESG factors are considered material in the credit risk assessment, the CRAs recognize them as ESG credit factors and integrate them into their evaluations. In the context of this thesis, it is crucial to understand investors and financial markets' motives in considering these factors relevant for a company's creditworthiness.

Since the early 2000s, extensive research has explored the potential link between sustainable performance and financial performance. Some studies have demonstrated a positive correlation between the two (Chodnicka-Jaworska, 2021; Cioli and al., 2023; Devalle et al., 2017; Kiesel and Lücke, 2019; PRI, 2017; PRI, 2018). However, the results are mixed, and the topic remains controversial (Kiesel and Lücke, 2019).

Additionally, various papers argue that ESG factors impact a company's credit risk (Billio et al., 2022; Bonacorsi et al., 2022; Chodnicka-Jaworska, 2021; Cioli et al., 2023; Devalle et al., 2017; Kiesel and Lücke, 2019; Yang, 2021; Zanin, 2021). Research by Yang (2021) and Zanin (2021) indicate that ESG components affect the probability of default differently. While some

studies highlight governance as the most significant factor (Fitch Ratings, 2021; PRI, 2018), Zanin (2021) suggests on the contrary that environmental factors are the more critical.

Ultimately, the integration of ESG parameters into corporate credit ratings is still in its early stages (Cioli et al., 2023) and consensus is difficult to reach among scholars. ESG factors' impact on credit risk varies depending on the company, sector, and geographic location (Moody's, 2023; PRI, 2017; PRI, 2018), which seems to be a prime reason for divergence. Nevertheless, traditional financial information alone is no longer sufficient to assess a company's credit risk, as literature agrees on the undeniable effect of ESG factors.

For instance, Billio et al. (2022) illustrate the impact of climate change, an environmental component of ESG, which can affect directly or indirectly a company's probability of default – a key factor in determining credit risk. Climate change can influence credit risk through physical risk, such as damage from extreme weather, and transition risk, which arises from “inappropriate or delayed adjustments and actions in response to climate transition” (Billio et al., 2022, p.46). Reputational risk is also a significant aspect of transition risk.

Therefore, it is no surprise that investors demand the integration of ESG factors into corporate credit risk evaluations to maximize their investments. Understanding how these factors influence creditworthiness allows investors to make more informed decisions, potentially achieving better alpha (PRI, 2017). Despite CRAs' claims of long-standing ESG consideration, investor pressure for transparency regarding the timing and extent of ESG integration continues to grow.

However, it is important to note that the integration of ESG factors may not be equally relevant for all investors. Indeed, institutional and retail investors have different desires and needs (Cash, 2021). Institutional investors, who manage and invest money on behalf of others, differ from retail investors, who are individual and non-professional investors (Chen, 2024; Hayes, 2024). Due to their varying capacities, resources, investments strategies and trade volumes, these two groups pursue different objectives and require different levels of data quality and quantity. Institutional investors, with their focus on long-term perspectives and desire to mitigate portfolio externalities, are the primary advocates for ESG integration. They also push for better comparability of reported information due to their extensive data usage. In contrast, retail investors, with different risk tolerances and a preference for short-term gains, may not necessarily be as interested in the integration of ESG factors into corporate credit ratings (Cash, 2021).

3.2 A journey riddled with challenges

Barriers to ESG integration

CRA's encounter several challenges when integrating ESG factors into company evaluations. The primary issue is the insufficient quality of ESG data used, which undoubtedly affects the willingness of CRA's to use them in their assessment (Cioli et al., 2023; PRI, 2017). Indeed, Jonsdottir et al. (2022) as well as Rogge and Ohneshorge (2022) highlight the lack of materiality, accuracy and reliability in the extra-financial information present on the financial markets. Improved standardization of non-financial information could certainly improve this issue according to Cash (2021).

Moreover, CRA's ability to conduct robust credit risk assessments depends heavily on data availability, also an obstacle identified by Fitch Ratings (2021). And when multiple data sources are available, selecting appropriate metrics becomes another critical issue (PRI, 2017).

Finally, incorporating ESG parameters into credit risk evaluations is complex. Academic and market research is limited (PRI, 2017), and no perfect guide exists for ESG-integrated assessments. Various measures, data sources, and weighting methods complicate the process (Billio et al., 2022). In addition, as mentioned in the previous section, ESG factors can affect corporate credit risk in multiple ways, both directly and indirectly (PRI, 2017), but their influence isn't consistently clear regarding its materiality, magnitude or when it may manifest (Cash, 2018a). Cioli et al. (2023) also mention the difficulty of separating the impact of ESG factors from traditional finance and economic indicators, which complicates the matter further.

Expectations gap between CRA's and investors

Developed by an internal group of institutional investors, the Principles for Responsible Investment (PRI) is supported by the UN and aims to promote responsible investing practices among the global investors' community (PRI, n.d.). Indeed, the movement has the objective to support its investor signatories (reaching 7,000 corporate signatories over 135 countries) in applying the PRI's six principles, considered as "a menu of possible actions for incorporating ESG issues into investment practice" (PRI, n.d.).

One initiative led by the PRI involves close collaboration with credit rating agencies to "enhance the systematic and transparent consideration of ESG issues in the assessment of the creditworthiness of borrowers in fixed income (FI) markets" (PRI, 2017, p.5). Through its project and discussions with both CRA's and investors, PRI has identified differences of

expectations, referred to as “disconnects”, with the objective of identifying actionable areas thereafter.

The primary major disconnect between the two parties according to PRI (2017) revolves around agreeing on what is the relevant time horizon to consider. As Cash (2018a) and PRI (2017) elaborate, the time horizon varies depending on the type of investors and instruments they used. Accordingly, long-term investors argue that CRAs ratings reflect a too-short perspective, and short-term investors hold the opposite view. Additionally, the timeframe remains unclear for assessing ESG risks, complicating matters further.

Moreover, the materiality of ESG factors to credit risk presents another significant challenge. We have discussed how ESG factors can variably affect the issuer’s likelihood of default. While CRAs claim to only consider these factors when they are deemed material to credit risk, investors often grapple with determining when they reach this threshold and whether the latter is acceptable for them. Given the ongoing ambiguity surrounding their influence, investors express a genuine need for clarity on when ESG factors are deemed material, and how they factor into credit ratings. For instance, investors advocate for more explicit references to long-term risks, more sector and scenario analyses beyond the CRAs’ typical horizon (PRI, 2017; PRI, 2018).

These two major disconnects of expectations in the CRAs-investors relationship underscore and intensify the already-mentioned issues for ESG integration in corporate credit ratings. At the heart of these challenges lies the problem of transparency and communication, which the PRI encourages CRAs to enhance. Investors are calling for a more systematic incorporation of ESG factors and are keen to ascertain whether CRAs are indeed doing so. Additionally, investors raise concerns about how CRAs perceive ESG factors, as they are not viewed as a distinct ESG category. This lack of categorization further obscures how CRAs integrate ESG factors and their potential impact on credit ratings (PRI, 2017; PRI, 2018; Cash, 2018a; Cash 2021).

3.3 Current state

Through PRI initiative (2016), several CRAs have enhanced the transparency of how they integrate ESG factors into credit analysis. The latest version of S&P Global’s report of 2021 outlines the impact of ESG factors on creditworthiness, but concerns persist about clarity and materiality assessment (Cash, 2021). Moody’s introduced Issuer Profile Scores (IPS) and Credit Impact Scores (CIS) in 2021, to boost transparency, though questions remain about their

foundational role and qualitative nature. Launched in 2019, Fitch Ratings' ESG Relevance Scores are designed to align with investor demands for greater transparency as well. Despite these advancements, challenges remain in ensuring precision and clarity in corporate credit ratings.

Cash (2021) specifically criticizes in S&P and Moody's report, the frequently repeated words « may » and « general », pointing out the subjectivity and the lack of thoroughness in their methodologies' explanations. Overall, it is clear for Cash (2018b) that they do not like scrutiny, and are reluctant to fully embrace transparency, likely to being held responsible, again, for any other disasters that might happen. But such a transparency reluctance can also suggest a lack of accountability and openness to improvement.

At the end, opinions differ regarding the extent of ESG factor integration into corporate credit ratings. On one side, the PRI (2017) argues that the main challenge lies in transparency rather than the inclusion of ESG factors. Conversely, there are assertions that CRAs have not performed satisfactorily in this area due to methodological issues, such as the use of generic methodologies applicable across various ratings and industries leaving, the lack of periodic methodology review, and a specific inadequate consideration of climate risk according to the Centre of International Environment Law's report mentioned in Cash (2018b). There is an overall significant room for improvement, and the limited existing literature on that matter does little to clarify the question.

Additionally, the motivation of CRAs' incorporate of ESG information is questioned. Cash (2018b) suggests that this integration is merely a survival tactic driven by increasing investor pressure. Despite the growing importance of investor interests, CRAs lack direct incentives to prioritize them as they are not compensated by investors to do so. This lack of incentives, coupled with methodological and transparency issues, raises doubt about CRAs' genuine commitment to ESG integration. Cash (2017), in its paper's title, describes the "long road ahead" for the financial market as it awaits the integration of ESG into credit ratings, warning against the ongoing trust in CRAs despite their role in the financial crisis. He criticizes their ESG integration efforts as a strategy to maintain legitimacy and evade accountability for past misconduct.

According to PRI (2017), a distinction should be made between the three industry's major players, and smaller or regional CRAs. While the leading agencies have made noticeable efforts, the smaller entities display less transparency in their methodologies and overall ESG

integration. Cash (2018b) notes that although smaller, socially responsible CRAs exist but struggle to survive in a market dominated by a few large players.

In the end, significant improvement has been made and the clarity of ESG integration into credit ratings is greater than ever before. However, challenges persist, including methodological inconsistencies and transparency concerns. And while efforts have been made for the Big Three, literature does not cover the smaller CRAs. The recent decision by S&P Global in August 2023 to cease publishing ESG credit indicator scores, which aimed to demonstrate their materiality in credit risk assessments, may not significantly impact the methodologies of CRAs. Yet, this move, highlighted by Lester (Environmental Finance, 2023), underscores the ongoing issue of transparency within the industry.

3.4 Recent related regulatory initiatives in the EU

In the European Union, the European Securities and Markets Authorities (ESMA) is the single entity overseeing CRAs regulated in the EU. ESMA's primary objectives are to enhance investor protection and maintain orderly and stable financial markets. Its key roles concerning CRAs include registration, supervision, and policy development (ESMA, n.d.-b).

In response to ongoing transparency issues regarding ESG factors involvement in credit ratings, authorities are now getting involved. The European Commission has mandated ESMA to analyze current practices regarding ESG factors integration into credit ratings and include ESG considerations in their Q2 2019 (European Commission, 2018). In response, the entity updated its Guidelines on Disclosure Requirements Applicable to Credit Ratings in July 2019, requiring CRAs to disclose in press releases or reports if ESG factors were key drivers behind rating changes, identify and explain their materiality, and provide links to their ESG integration methodologies (ESMA, 2019).

More recently, in early April 2024, ESMA initiated a consultation on proposed amendments to the CRA regulatory framework. These amendments aim to enhance the integration of ESG factors into CRA's credit rating methodologies, and subsequent public disclosures, thereby further improving credibility and transparency of their processes (ESMA, 2024).

3.5 Effect of the NFRD

In light of the challenges confronting CRAs in integrating ESG factors into credit rating processes, this section examines the effectiveness of the NFRD, designed to improve consistency and comparability of non-financial information, in enhancing the integration of these factors.

According to the work of Fiechter et al. (2022), the directive has significantly improved transparency, content quality, international comparability and credibility among the EU studied firms. Even more, these companies started to enhance it before the reporting mandate came into effect. These observations align with Christensen et al. (2021), who argue that NFRD had the potential to foster harmonization in non-financial reporting, particularly within industries. Notably, they are the only researchers addressing the impact of the directive on financial intermediaries, including CRAs, emphasizing its role in favoring reports with external assurance, thereby bolstering their reliability.

Breijer and Orij (2022) offer a different perspective, highlighting that the directive does not mandate adherence to a specific reporting framework, which significantly challenges the harmonization of non-financial information. Nevertheless, their research indicates that the implementation of the directive has led to an overall improvement in comparability between sustainability reports.

Despite the potential benefits the directive had, research on the effects of NDRD remains relatively limited. While it recognized that the directive could enhance information for users of non-financial reporting, the extent of this impact remains uncertain (Christensen et al., 2021), even more for credit rating agencies.

4. Conclusion & literature's gap

The literature reviewed the increasing integration of ESG factors in financial markets, and the objectives of mandatory sustainability reporting directives, with a particular focus on the newly implemented CSRD, designed to rectify the shortcomings of the NFRD. Seeking to boost transparency and accountability, the CSRD intends to enhance the quality, comparability, and accessibility of sustainability disclosures by corporations. Furthermore, the literature delved into the complex integration of ESG factors into corporate credit ratings, underscoring the challenges faced by CRAs in terms of the quality and comparability of non-financial information. The complexity of assessing ESG impacts on credit ratings is exacerbated by investor demands for greater transparency to inform their investment choices.

Despite these developments, existing research on the actual extent of ESG integration by CRAs is limited, with no precision for the EU specifically, and studies on the impact of regulatory directives such as the NFRD and CSRD on this integration are absent. No substantive findings exist regarding the NFRD's impact, and with CSRD reports still pending, empirical evidence is lacking for the latter. Therefore, this thesis aims to bridge this gap, by examining the current

state of ESG integration into corporate credit ratings within the EU, and investigating whether the CSRD can facilitate this process, thus addressing a critical void in existing literature.

METHODOLOGY

1. Research type

To address the exploratory nature of our research question, a qualitative approach was selected to align with the objectives of understanding the integration of ESG factors into EU corporate credit ratings and of assessing the potential impact of the CSRD. Indeed, our study requires an exploratory approach because it addresses an as-yet-unexplored area. Firstly, the first CSRD reports are not scheduled for publication until 2025. Consequently, our research must focus on the expectations of the various stakeholders with regard to the implementation of the CSRD. Secondly, given the paucity of literature the ESG integration level in CRAs, an exploratory approach is the optimal method for uncovering the reality on the ground, and what are the anticipated changes and challenges.

Among the different analysis methods in exploratory research, we chose to conduct interviews, which was motivated by several reasons. First, this approach allows us to gather diverse perspectives, offering a holistic view of the dynamics involved. It provides rich and narrative insights into current practices, perceptions and challenges not yet documented by the literature. The format of semi-structured interviews will provide flexibility in adapting questions during the interviews, providing us the opportunity to delve deeper into emerging topics that might arise. Indeed, semi-structured interviews are useful when trying to capture the different viewpoints of the dynamics at play. Additionally, this type of interviews has the potential to make participants more at ease. By choosing them, we are hoping for more honest and insightful responses.

2. Construction of interview guides

To construct the semi-structured interview guides, the key themes and objectives were first defined, based on the research questions and the literature review. These themes helped us draft a series of open-ended questions designed to encourage detailed responses, while still allowing flexibility to explore new topics as they emerge, with follow-up questions if development was needed. The different guides of semi-structured interviews, tailored to the different groups of interviewees, can be found in Appendix 3.

3. Participants

Different groups of participants were interviewed, in order to get a thorough understanding of the issue addressed by the research question. Indeed, we engaged with four types of participants. First, “CSRD experts”⁴ for their expertise and insight on the new EU directive. Second, “sustainability managers” for their unique and internal perspective on the CSRD implementation within an EU-based company. We chose to focus on companies of the first group, required to publish their first CSRD report in 2025, based on the financial year 2024, for their unique and internal perspective on the CSRD implementation within the EU. These companies are considered the most prepared, and thus, we expected them to offer the most insightful contributions. Next, credit risk analysts from EU-based CRAs were also interviewed to explore their current practices in terms of ESG integration into corporate credit ratings, and any expectations they have regarding the CSRD’s impact on the integration. Lastly, professionals with an external perspective on the matter to provide a broader view of the challenges and dynamics involved.

Their selection was conducted with several criteria in mind, with the objective of obtaining diverse views. Consequently, we paid attention to interviewing individuals with varying levels of experience, across distinct industries and geographies and types of companies. The recruitment process involved the identification of potential participants through personal professional networks, companies’ websites, and the social media platform LinkedIn, followed by contacting them via email or LinkedIn. Specific lists from ESMA and the National Bank of Belgium (NBB) helped targeting more effectively CRAs and sustainability managers respectively (ESMA, n.d.-a; NBB, 2024).

The screening was proceeded to ensure that participants met the selection criteria. However, we encountered challenges in finding credit risk analysts with different experience levels and perspectives. We were unable to secure interviews with top executives, or members of the methodology teams, which would have brought us a more detailed and wide-ranging view. Regarding geographical diversity, although most CRAs interviews were conducted with participants based in France, the consistent application of the same methodology across the EU meets our criteria. Moreover, of the three sustainability managers interviewed, two are employed by companies with operations spanning the continent.

⁴ The quotation marks are used to denote that individuals in the group do not hold an official job title matching those terms, but rather categorize individuals by their areas of interest for ease of reference in our study. For lecture facility, they won’t appear next time the names of groups’ interviewees will be mentioned.

Despite challenges, we successfully interviewed four CSRD experts, three sustainability managers, five credit risk analysts, and one professional with an external perspective. A list providing an overview of the participants interviewed, along with descriptions of the companies they are or were working for, can be found in Appendix 1 and Appendix 2 respectively. Some participants requested anonymity regarding their names and the companies' names. For this reason, we anonymized their identities to respect their demands. The anonymity pseudonyms can also be found in the same appendices.

4. Analysis

After conducting interviews, we proceeded with a thematic analysis, by first transcribing them meticulously (Appendix 4). Following this, we chose to code our interviews after several proofreadings, aiming for the data to speak for itself. Several themes stood out for different groups and sub-groups of interviewed participants. Therefore, we separate them accordingly to structure the findings and illustrate them with verbatims: first by groups or sub-groups, then by themes.

RESULTS

1. CSRD experts, Sustainability managers & External perspective

While the interviewees fall into two different categories – external CSRD experts and internal company sustainability managers working within the company – both offer common insights. For this reason, they have been grouped together in this first part of the results section. The external perspective, being a risk consultant, and because he had knowledge about the CSRD, is also included in this section.

1.1 Corporate Sustainability Reporting Directive

NFRD shortcomings

The interviews underscored several shortcomings of the Non-Financial Reporting Directive (NFRD), the current reporting directive that is set to be replaced by the Corporate Sustainability Reporting Directive (CSRD).

A common issue among interviewees was the lack of standardized reporting, which made it challenging to compare companies and extract meaningful information for investment or financial decisions. Schrek, co-founder of E-Learning ESG highlighted that despite the existing legal framework, issues of comparability and quality were present: "... nothing was very well

framed. All companies proceeded in their own way, which posed problems of comparability between companies, and above all, the veracity of the data produced”.

The absence of verification for the data and information in the reports further exacerbated these concerns. Interviewees noted that without proper control, companies often publish only positive aspects, leading to potential greenwashing. “The current issue is that companies are disclosing whatever they want... there are themes that they don't address at all” (Tordeur, founder of Owise). As one sustainability manager noted: “...a lot of time, companies would never publish things that are not positive” (Blake). At the end, the reliability of information is significant issue, depending on the company: “there are companies that take this to heart, and I've read about some where it is good, but others... it is not catastrophic, but it's not great” (Tordeur). For this reason, Head of sustainability Morgan emphasized caution in using these reports for investment decisions: “... if you're thinking outside our portfolio, I wouldn't make investment decision and I'll be very careful drawing any conclusions based on the company's reports”.

Lastly, a final issue remains the scope of companies subject to the NFRD, as only a small part of EU's companies is concerned. It “was also unacceptable because if you have, you know, a union of countries where 99% of businesses are small businesses...even though they're [the NFRD targeted companies] massive, it doesn't make as much sense” (Mercer).

CSRD purpose

In discussion with interviewees, the true intent of the CSRD behind new reporting requirements emerged: to enhance transparency and drive companies towards greater sustainability goals. The increased transparency is designed to indirectly motivate companies to act: “in practice, it also leads to action, even though it's not a required action since it's only transparency. So, it has a very good and clever setup” (Morgan). Pijcke articulated the Commission's ultimate objective as fostering “a virtuous and positive emulation to push companies in the right direction”. She highlighted two main sources of pressure: “the first Damocles sword is the one of auditors. The second is the fact that you have to publish what you do or don't do”, the latter further influenced by the reputational effect described by Mercer.

Indeed, this regulatory approach not only encourages compliance but also aims to foster environmental and social benefits, as noted by Schrek who considers it as a welcomed trigger and “a good think for the environment, the planet et people”, as also detailed by Mercer: “it

has the possibility to have a really good impact on your own workers, or people who are in the value chain, or even the communities you affect”.

CSRD compliance challenges

Interviewees unanimously agreed that achieving CSRD compliance presents significant challenges for companies. Mercer highlighted the current uncertainty among them: “...there is a little bit of a crisis right now for companies that know they are going to be compliant with it for next year and they don’t know how it is going to work”. Indeed, the process itself is arduous, as noted by the same analyst: “there needs to be a lot of work put into it, just to determine what you mean by DMA [Double Materiality Assessment]. Like even that step, it is an insane amount of work, it is months of work actually” (Mercer). Tordeur further emphasized the complexity of navigating between the ESRS, likening it to “a labyrinth”.

Financial and human resources constraints exacerbate these challenges, as noted by Morgan: “It is however a challenge to reach full CSRD compliance and there's a very lack of resources and time to make this happen”. In fact, Mercer underscored the clear issue of insufficient human resources in the compliance process:

“Just the amount of human capital that needs to be allocated in order to make sure that you applied the correct regulation, that nothing has been changed, that everything is up to date, that part of keeping up with the evolution of regulations is a huge one”.

Many companies opt to outsource the process, or at least a part of it, to consultants due to the extent of its complexity: “it is a very complex process I find. We used a consultant to help us because it’s really complicated” (Pijcke). Financial considerations also need to be taken into account in this transformation, whether companies opt to use consultants, or handle the process internally, or both. Time pressures further complicate the process, as Tordeur admitted: “deadlines are very tight.”

From an organizational point of view, “the data collection part and management are a huge issue. Just the fact that a lot of this information does not exist is also a huge thing” (Mercer). This task is compounded by the need to gather data from diverse affiliates, suppliers, and clients across geographical locations and regulatory environments, as explained by Mercer and Blake.

The level of difficulty in achieving CSRD compliance varies depending on company size, sector and also maturity level in sustainability practices. Smaller companies, as observed by Morgan, face greater challenges “...in how to get this comprehensive data collected and due to

a lack of expertise and resources”. Pijcke also mentioned that: “it is really going to be even more complex because sometimes some of them don’t even have a juridic or sustainability department”.

Blake highlighted additional hurdles related to being pioneers in compliance efforts as comparison isn’t possible, but also regarding the change management that is needed internally: “for a lot of people, it's something extra that comes on top of their job”. Moreover, the differing perspectives and interpretations of the directive between consultants and experts add complexity: “all the different consulting companies give different advice. Everyone has their own perspective on it, their own understanding” (Blake), as echoed by Pijcke: “that’s very stressful because they are feeling that they are being played” (Pijcke).

Expected effects of the CSRD

All interviewees seemed to agree that the effects of the CSRD compared to the NFRD are uncertain. While it is expected to bring improvements across various levels, the extent of these improvements remains unclear, especially in the short term.

Due to the phased implementation, the positive effects are to be expected more in the long term and will become more evident over time. As Tordeur mentioned: “the CSRD will help, but on the long-term”. Indeed, sector-specific standards are planned for publication in the coming years. Assurance standards and sanctions also still need to be transcribed nationally, which will further shape the landscape of CSRD compliance and effectiveness.

First, transparency in corporate sustainability reporting is expected to increase. Drion highlighted the availability and reliability of data: “there will be more and more available data... we will be able to trust more these information”. Additionally, “this data is going to be retrieved in a coherent and uniform way, especially from a huge number of market players” (Synadino).

While SMEs are not required to report in the initial phases, they will also be impacted earlier due to their relationships with suppliers and clients. Entities from their supply chain might need to report sooner, and will request sustainability information from them: “small businesses are going to be affected more quickly than they think, because they themselves are suppliers or customers of the large companies... I think this will have a snowball effect” (Pijcke).

Several interviewees noted that the accountability of the Board has already been enhanced. While Boards were already accountable for the information provided, the inclusion of the

sustainability report in annual reports intensifies this responsibility: “they feel more accountable than before because it's so clearly explicit in the standard and in the regulation, and that puts better attention to sustainability than before” (Morgan).

Despite the expected improvements in transparency and accountability, there are concerns about the practicalities of the new reporting standards. One concern is the potential difficulty in digesting the reports. Schrek warned that: “many are saying that these reports are going to be ingestible”. In line with this statement, Mercer pointed out that “these reports are like, two hundred pages, three hundred pages...of information”, based on pre-CSRSD reports already published as examples. Moreover, while all agreed on the enhanced comparability post-CSRSD period, the extent of this improvement is questionable, especially in the short term. “The standards are not perfect, to be the short explanation. So, there are a lot of elements in the standards that are still up for development and interpretation” (Morgan).

Additionally, Mercer brought up the freedom and flexibility in the CSRSD reports' structure, because the ESRS allow for some anti-specific disclosures. From the pre-CSRSD reports mentioned, she noticed that: “everyone is showing different information in different ways, what we are seeing is very, very different versions of these reports”. Blake further described the variability in both quantitative and qualitative reporting requirements, and questioning even more the comparability results:

“Calculation behind the metrics is still going to be different. Because we still have room for our own interpretation and CSRSD says that as long as you explain how you did the calculation or the thing, it's okay for them” (Blake).

The extent of qualitative information requested by the ESRS, while important, could also pose issues for comparability: “it does affect comparability, and affects transparency as well as at the end of the day because they get to word things in ways that might make them look better” (Mercer).

1.2 Concerned stakeholders

Participants consistently focused on the financial market when discussing who would benefit the most from the new reporting requirements.

According to Morgan, “the financial market is the key audience” in this directive. Some specifically referred to investors, such as Pijcke: “they will gain in transparency and so they will better understand what the long-term strategy is in the company they invested”.

Furthermore, two interviewees pointed out that the directive could help credit rating agencies in their use of non-financial information: “but the day where all companies will be concerned by the CSRD, they will have all information, or at least a part of the information they need” (Pijcke). In addition to more available information, Drion mentioned that they will be also able to trust it: “the fact that the data will be audited will really improve for credit rating agencies the reliability of data that they will be able to use”.

Finally, Synadino pointed out that ESG integration is a question for everyone in the market. CRAs are also gathering extensive data trying to improve their ratings and tools integrating ESG aspects: “The credit rating agencies are trying, like everyone else, to gather as much data as possible to provide answers to these questions” (Synadino).

2. All credit rating agencies & External perspective

2.1 Relevance of ESG factors into corporate credit ratings

The participants explained the relevance of ESG factors to corporate credit ratings, illustrating many examples for each ESG component. These factors offer crucial insights into non-financial risks that traditional analysis might overlook, thereby providing a more comprehensive assessment of a company’s creditworthiness. One interviewee emphasized the significance of ESG factors, stating: “ESG factors should be viewed as any other kind of non-financial factor” (Forsberg), stressing the need for analysts to assess material ESG factors. To illustrate her point, she explained that “all or most of our analysts have undergone an ESG analysis training to ensure that, you know, every analyst is able to sort of make this assessment of what are material ESG factors...” (Forsberg).

Reputational risk linked to ESG factors emerge as a key consideration when evaluating companies. As Moreau noted: “Reputational risk is a risk to which we pay particular attention in our analyses, as a company's ESG practices can have a significant impact on its reputation, with far-reaching consequences for the company”. For instance, Synadino explained that: “Tomorrow, if you find out that your bank has invested in an oil well in the middle of an Amazon rainforest, ... you might want to move all your money. It's kind of the same idea.”

Additionally, interviewees agreed that ESG factors affect sectors differently: “The [ESG integration] methodology was created for all business sectors, but there are of course specificities for each sector” (Blanchart).

3. Dominant CRAs

3.1 ESG integration

Both interviewees from major CRAs confirmed the inclusion of ESG factors into their credit rating processes. As one credit analyst stated: “We cannot deny it, the ESG is still a part of our analyses, and in our reports, there will always be an ESG paragraph” (Moreau).

At CRA.1, while ESG factors are not primary determinants of credit ratings, they are consistently considered: “There is no compulsory ESG component, in the sense that there are other factors to consider... So, it’s not going to appear directly, but it’s really something we’re going to consider in the background” (Moreau). The analyst also mentioned that at the end, while methodologies are the same, subjectivity is present: “every analyst has his own way of thinking at reporting things”. Additionally, ESG factors do not significantly impact the credit rating itself in their analyses: “maybe it won’t determine if it is a B+ or B-, however it is going to determine our vision of the company in its rating” (Moreau).

At CRA.2, the methodology differs slightly. The agency has developed two distinct scores: Score_A and Score_B⁵, the two being rated on scale of one to five. The first evaluates the extent to which ESG factors explain the corporate credit rating: “what is the part of the analyst that is attributed to the ESG?” (Blanchart). The credit analyst emphasized that Score_A is not an ESG score itself, and does not directly impact the credit rating: “it is a complementary assessment and does not bring real change to presented final ratings”.

Furthermore, the agency has developed Score_B, which categorizes the three components of ESG and represents the ESG score of the company on those specific matters. Nevertheless, Score_B isn’t directly reflected in the analysis either. When explaining how the scorecard depicts the different sub-scores building up the rating, the credit analyst explained: “It’s not integrated into the scorecard. It’s part of the analysis, but it doesn’t influence it. You see, it’s not part of the equation. It’s on the side, it’s considered, but it’s not systematic” (Blanchart).

At the end of the conversation, Blanchart highlighted the difficulty of integrating ESG factors into credit ratings, because “agencies don’t have the tools and competencies internally. It is a lot of tinkering, and nothing concrete”.

⁵ The names of the two scores has been anonymized to avoid the company getting identified.

3.2 Use of corporate sustainability reports

To include ESG factors, CRAs need to source their extra-financial information from various channels. According to both interviewees, the main sources are corporate sustainability reports information and discussions with the company's management itself: "I'm really going to go and get the company's sustainability report. It's really the first thing I'm going to look at... And then we'll simply discuss it with the management." (Moreau)

Management interviews are indeed crucial for accurate information, since sustainability reports are not always easy to exploit: "...we often have to look for information ourselves" (Blanchart). Moreau explained that: "all things related to sustainability/ESG is still at its initial stage" and that she does not hesitate to go look for other sources such as internet and press releases.

Our discussions highlighted issues regarding the quality and comparability of information in sustainability reports, and whether credit analysts should trust that information. From sustainability reports, it is difficult to discern what the company is actually doing, and to separate what is greenwashing from genuine efforts: "there's also the question of avoiding greenwashing, of making sure we understand what the company is doing. Is it doing it out of overzealousness, or is it really doing it to accelerate its energy transition?" (Moreau). The lack of common reporting standard complicates things further: "And it's very difficult to find your way around because there's no standard reporting" (Moreau).

However, this issue would apparently mainly concern smaller companies, not yet targeted by EU reporting regulations: "the comparability is an important challenge, mostly between listed and non-listed companies" (Blanchart). Moreau aligned with this by saying that "their sustainability reports are generally well detailed", when talking about large companies, and because credit analysts are working on a specific sector, "it is possible to cross-check between what actors are saying and what they are doing". At the end, it is also an issue of having enough quantitative metrics: "we currently have a lot of qualitative information, and not enough quantitative metrics" (Blanchart).

3.3 CSRD effect on EU corporate credit ratings

The CSRD is well-received by both interviewees. Based on Moreau, it will help "regarding the comparability and analysis depth that we will be able to bring". The interviewee specifies that it will be a great help in comparing similar companies and understanding sectoral trends.

Blanchart said: "...as soon as data is published, the first thing that's going to help a lot is to have the information. Secondly, the information will be standardized. And this will make it

easier to compare”. Indeed, the interviewee believes it will create a foundation to build their comparison and get an overall overview of sector activities.

Ultimately, the same analyst sees the CSRD as a solution for enhancing ESG integration into corporate credit ratings: “I think that the CSRD will help to improve the accuracy and quality of ratings. ... I think CSRD will help to bridge the gap between the two and understand the impact of ESG factors on credit ratings” (Blanchart).

4. Smaller CRAs

4.1 ESG integration

All smaller CRAs explained that they consider ESG factors when evaluating the creditworthiness of companies. However, their methodologies differ. While EthiFinance has established a precise ESG scoring system to facilitate ESG integration into corporate credit ratings, Scope Ratings and Nordic Credit Rating follow a less-defined approach.

EthiFinance

At EthiFinance, Mouaacha highlighted that the agency, based in France and Spain, has a competitive advantage over other CRAs, especially the Big Three. Indeed, while the larger agencies had to acquire ESG providers and specialists in ESG ratings, EthiFinance has dedicated ESG teams in place. Blanchart even mentioned them in her own interview: “they have ESG in their DNA, much more so than a traditional agency which buys an ESG service provider”.

To gather non-financial information, EthiFinance has developed an ESG-specific questionnaire, demanding both qualitative and quantitative answers, that companies must complete. For listed companies however, the data is sourced from their existing sustainability reports: “if it's public, it will be sourced from the sustainability report because that's the main source of data for all investors for all stakeholders and all market players” (Mouaacha). For other companies, new information is collected through the questionnaires.

At the end, once ESG data is gathered, the credit analyst has access to all ESG scores for each component, calculated by the ESG team. This integration is streamlined: “...when I click on a simple button, it gives me the scores for each pillar E, S and G and it actually calculates the KPIs according to a specific weighting that we have”, said Mouaacha. Additionally, a second questionnaire focusing on more credit-related questions assists the analyst in building the overall rating.

Scope Ratings

This agency evaluates creditworthiness of companies based on two main aspects. First, financial analysis determines both the business risk profile and the financial risk profile. ESG factors are considered afterwards as supplementary rating drivers: “where we include the ESG approach, starting with the governance and transparency. Then we apply the environmental and social aspects, and then we finalize with financial policy” (Gomez).

In describing these supplementary rating drivers, Gomez explained: “we try to assess short-term or medium-term, create positive or create negative aspects that might impact the rating itself”. But it is not an easy task: “I will say that all the rating agencies have similar issues as to how to assess the environmental risk in the very short term. And how this risk might impact the rating” (Gomez). Due to complexity of assessing the impact on credit, the potential ESG effects are often more reflected under red, green, or grey flags, with further explanations provided in the rating action release, where the rating is justified. Gomez further elaborated: “We are giving more like a flavor in the investor saying that we detect that the company is exposed to this or to that in the ESG, ..., we highlight that the rating might be jeopardized if it happens”.

However, these flags do not directly impact the rating itself as clarified by Gomez: “if it's not material, it's difficult to assess. We might only highlight a red flag or green flag, but it doesn't mean that the rating will be impacted”. This nuanced approach ensures that while ESG considerations are communicated to investors, they do not significantly influence the credit rating, unless they are deemed material.

Nordic Credit Rating

At Nordic Credit Rating, the integration of ESG factors is also considered. As Forsberg explained: “in theory, what we're aiming for is that ESG factors should be viewed as any other kind of non-financial factor”.

Their methodology involves examining different components, broadly categorized into business risk and financial risk, themselves differentiated into sub-categories, to understand how ESG factors might impact on these areas. Credit analysts are asking themselves: “where are the factors that are impacting our assessment of this subcategory of the methodology of the rating?” (Forsberg). Additionally, the agency has a set of adjustments to the final credit rating, which includes ESG: “So we do have that option as well for a negative adjustment notch there. And those would be cases where we say, okay, this isn't covered elsewhere.” (Forsberg)

Moreover, Forsberg specified the benefit of having qualitative information to be able to get a broader view of ESG aspect, as getting a quantified impact on companies' creditworthiness is complex: "I think part of the beauty of credit ratings is that we're not strictly limited to what can be quantified or not... you're able to take a broader view of ESG factors in the creditworthiness as well".

4.2 Use of corporate sustainability reports

At EthiFinance, sustainability information is used to build up ESG scores for listed companies. Mouaacha expressed confidence in the quality and comparability of this information: "These companies have obligations to report various metrics because there is a lot at stake, so they tend to report accurately. Even though there are differences in how these companies report, they generally provide the same metrics if available".

However, he pointed out a significant challenge with smaller companies, which often do not provide a detailed sustainability reporting: "To be honest, I've never encountered a small company that provided comprehensive ESG reporting, simply because they are not required to do so." (Mouaacha). Furthermore, he introduced the issue of lack of standardization in ESG score methodologies and the resulting variability in ratings: "variability makes the ratings somewhat unstable" (Mouaacha).

As Mouaacha, Gomez also observed from its experience that large corporations are generally obliged to publish sustainability information, while smaller companies are more focused on production and less on reporting: "For large corporations, the information is there because they are more or less mandatory obliged to publish, you know. However, for the meat in the small market, it is not the same because they are more focused on the production." (Gomez).

He also elaborated that sustainability reports often lack depth and tend to be overly promotional: "I mean, sustainability reports that I use, they are very marketing" (Gomez). This necessitates additional efforts to extract meaningful information, often involving kick-off calls with management for more material insights. Forsberg also emphasized the importance of direct communication with companies over information provided in sustainability reports, where finding material ESG aspect is complex: "What we get from talking to the companies is in most cases more important than what we get from the sustainability reports themselves."

Both Forsberg and Gomez are advising caution due to potential greenwashing in these reports: "You always have to take sustainability reports with sort of a grain of salt because even if, I mean, there's more or less active greenwashing..." (Forsberg). She often reviews multiple

reports from the same sector to enhance understanding and explained that even in Sweden, where sustainability reports for large companies must be audited, these audits do not cover all data, necessitating careful scrutiny.

4.3 CSRD effect on EU corporate credit ratings

The CSRD is anticipated to significantly affect ESG evaluation by providing a basis for comparison and standardizing sustainability reporting for interviewees of smaller CRAs.

Gomez from Scope Ratings suggested that stronger guidelines from regulators under CSRD will likely change sustainability reports and, consequently, the evaluation process: “If the company has already an important way, stronger guidelines from the regulator, obviously the sustainability reports might be changed, and therefore the evaluation as well. I will suggest that we need to see the impact first.” He acknowledged that if CSRD brings significant changes, CRAs will need to integrate these into their rating processes.

Forsberg also anticipates a substantial impact from CSRD, noting that it will lead to more transparent and comparable reports. Additionally, “...it's also going to help us identify risks and opportunities that we maybe couldn't identify before” (Forsberg), improving rating depth.

Finally, Mouaacha believes that it will make it easier to understand ESG scores and facilitate ESG integration: “For companies, it will bring for sure a basis for comparison between these different scores. Because at the end of the day, investors get lost between all these issues and it's very complicated, like ESG integration is very complicated”. Nevertheless, he added that the true impact will depend on how companies adopt and implement them.

5. Summary of findings

Interviews with CSRD experts and sustainability managers revealed that while the CSRD aims to enhance transparency and sustainability, it poses significant compliance challenges: standards complexity, resource demands and strict timelines. Despite some short-term uncertainties, long-term benefits such as enhanced data availability, quality, comparability, and corporate accountability in the EU are expected. Conversely, credit risk analysts underscored the importance of integrating ESG factors into corporate credit ratings, but are facing challenges due to the variability and quality issues of ESG information, particularly for small businesses, making sustainability reports only marginally useful for credit assessments. Hence, discussions with companies' management are crucial. Overall, the CSRD is viewed favorably, expected to standardize ESG data and improve the quality and depth of corporate credit ratings.

DISCUSSION

1. Convergence with literature

1.1 Corporate Sustainability Reporting Directive

The literature and findings concur on the purpose and objectives of the CSRD. Indeed, the CSRD aims to address the limitations of the NFRD, specifically in terms of lack of standardization and details in reporting requirements. Both CSRD experts and sustainability managers agreed that sustainability reports under NFRD are difficult to compare, incomplete, and insufficient for financial markets that want to take into account non-financial considerations into their decisions. Ultimately, the primary goal of the CSRD is to encourage companies to commit more fully to sustainability by using transparency as a form of pressure.

1.2 Current state of ESG integration into corporate credit ratings

Our findings corroborate the literature regarding the efforts of major CRAs to increase transparency in how ESG factors influence credit ratings. For instance, CRA.2 has developed scores to explain how ESG considerations are factored in their analysis and CRAs must disclose the main drivers behind ratings, including ESG factors.

However, the integration of ESG factors into final ratings is for many non-systematic and varies by credit analyst, often serving as secondary rather than primary considerations. This supports the literature's assertion that while ESG factors are recognized to be primordial for corporate creditworthiness, their direct impact on credit ratings is limited. For instance, ESG considerations are only treated as "flags", as indicators of potential issues, or the developed scores do not influence the final rating. Moreover, ESG factors are frequently obscured within minor subcategories.

Finally, while some CRAs have relatively defined methodologies in place, such as EthiFinance which builds ESG scores based on questionnaires, others maintain a vaguer approach. This confirms the literature's description of a general, somewhat imprecise approach to ESG integration that lacks depth and precision. The term "tinkering" used by one interviewee aptly captures the ongoing, tentative efforts to incorporate ESG factors more systematically.

2. Divergence with literature

2.1 Challenges for ESG factors integration

The literature describes significant challenges that CRAs face when integrating ESG factors into corporate credit ratings. A major issue is the lack of standardized and high-quality non-

financial information. However, the findings, centered on the EU perspective, reveal mixed opinions on this matter. While there is consensus that reliable, standardized extra-financial information is lacking, this challenge is especially pronounced when evaluating small businesses as they don't have any mandatory reporting standards at all.

According to the findings, although deficiencies in sustainability reports also exist among large EU-based companies, they do not significantly obstruct the evaluation process. Nonetheless, the quality and reliability of these reports are still often questionable, with some data potentially being influenced by marketing motives rather than reflecting genuine sustainability efforts, depending on the company. Consequently, extracting useful information from these reports requires caution. Discussions with company management remain their primary means of gathering accurate insights and mitigate these issues, as provided information generally doesn't offer enough color to determine the rating.

Furthermore, there is a lack of standardized ESG score methodologies, which impacts credit ratings. Each CRA who builds such scores has its own methodology, leading to inconsistencies and sensitivities in how ESG factors are considered. Other obstacles include the lack of quantified metrics, and the limited internal competencies and tools available to CRAs for thorough ESG analysis. This highlights the broader issue of integrating ESG factors into credit ratings, emphasizing the need for better resources and methodologies to effectively incorporate these crucial factors.

Ultimately, literature and interviews diverge considerably on the practical difficulties of integrating ESG factors into corporate credit ratings, which may be partly due to the fact that the literature offers a general perspective, that does not specifically address the EU context. The only converging challenge is the difficulty in assessing the materiality of ESG factors in the short term and determining the extent of their impact on credit ratings.

3. Emerging insights

3.1 CSRD compliance challenges

Discussions provided new insights into the challenges of complying with CSRD for companies. Interviewees unanimously emphasized its significant impact on companies. Indeed, the process is described as exceptionally demanding, creating a sense of "crisis" as firms strive to meet requirements without clear guidance. Diverse interpretations among consultants and experts further complicate matters, intensifying stress and uncertainty.

The extensive nature of the work, particularly the months-long double materiality assessment, indicates the magnitude of the task. Companies navigating ESRS standards find them akin to a labyrinth, complicating compliance efforts.

CSRD compliance demands substantial resources, exacerbated by limited time and human capital within organizations. Many companies resort to outsourcing parts of the process to consultants due to the complexity and stringent timelines, which also incurs additional costs. Organizational challenges include gathering dispersed data from global affiliates, suppliers, and clients.

Achieving compliance varies based on company size, sector, and sustainability commitment maturity. Smaller firms and SMEs, lacking resources and dedicated departments, face heightened difficulties.

3.2 ESG integration level: comparison between dominant and smaller CRAs

Because the literature focuses on larger CRAs dominating the global market, it overlooks smaller CRAs. Thankfully, our findings allow us to obtain a more holistic view of the EU market and reveal comparisons between these two types of CRAs in their ESG integration.

Our findings suggest that the state of ESG integration in the EU is rather similar across both categories, likely because they all need to make the minimal efforts required by regulations. Notably, EthiFinance stands out for making sustainability its core value, and establishing a more defined and quantified ESG integration process.

Nevertheless, one significant difference is the amount of attention the dominant EU-based CRAs receive compared to the smaller entities. This heightened scrutiny subjects them to greater market pressures, compelling them to show transparency, such as developing scores to satisfy stakeholders.

3.3 CSRD expected effects

The literature only focused on the objectives of the CSRD. The findings bring insights regarding the expectations from various financial market participants of the effects of the CSRD on corporate sustainability reports, and corporate credit ratings across the EU.

On corporate sustainability reports

Improvements are expected in many areas, but the extent ability of the CSRD to effectively address issues present in the NFRD remains uncertain, especially for the short-term. Indeed, long-term benefits are predicted but only once the CSRD's implementation is complete,

through the various target groups of businesses. Indeed, the market is awaiting the publication of sector-specific ESRS standards, assurance standards and national sanctions, that all will certainly shape CSRD compliance and effectiveness.

In the long-term benefits lie the increase of transparency, data availability and reliability. Additionally, even if SMEs are not initially required to report in the early stages, they will nonetheless be quickly involved through their roles in the supply chain, creating a snowball effect. Board accountability for sustainability matters is expected to be heightened, and has even already intensified, with the inclusion of sustainability reports in annual reports.

Ultimately, some concerns exist about the new reports created under CSRD requirements. Issues such as its excessive length, the variability in report content and structure present challenges to comparability.

On corporate credit ratings

Reports of better quality and allowing for comparability between companies across the same sectors are expected to have a real impact on financial markets in the EU. Additionally, because it will affect a considerable larger scope of companies, the quantity of available data is going to empower many actors in financial markets. Investors, in particular, will benefit from better-informed decision-making processes by incorporating more reliable extra-financial considerations and understanding long-term strategies.

The interviews also reveal that the CSRD is expected to affect corporate credit ratings, by enhancing ESG evaluation and standardizing sustainability reporting. It will provide a basis for comparison, increase transparency, and improve data reliability and accessibility, leading to more accurate and in-depth ratings. New risks and opportunities are expected to be identifiable, many of which were often overlooked before.

Ultimately, the CSRD is predicted to simplify ESG integration into EU corporate credit ratings, and facilitate the comparison of similar companies and sectoral trends, which is a crucial part in the analysis of credit risk analysts. Furthermore, its effect is foreseen to be more important when evaluating small instead of large companies. While the directive promises improvements in corporate sustainability reports and credit ratings, its true impact will depend on effective implementation and forthcoming standards. Small CRAs remain cautious, highlighting the need for careful observation.

CONCLUSION

This thesis aimed to examine whether the introduction of the CSRD could facilitate the integration of ESG factors into EU corporate credit ratings, based on expectations from various stakeholders, and by answering the question: *“How can the introduction of the CSRD can facilitate the ESG factors integration into corporate credit ratings within the EU?”*

To address this question, a review of the existing literature was conducted. Subsequently, thirteen interviews were held with CSRD experts, sustainability managers, credit rating analysts, and a risk consultant, providing emerging insights.

1. Contributions

Our research first delved into the **CSRD’s expected impact on non-financial information**, aligning with the existing literature. The CSRD is expected to enhance quality, availability and comparability of ESG information through stricter reporting requirements, addressing NFRD limitations, and improving transparency and accountability. Yet, companies face considerable challenges in adapting to these new standards, such as standards complexity, resource demands and strict timelines. Despite anticipated improvements, this thesis highlights **several short-term uncertainties**. The extent of the improvements remains unclear, as not all targeted companies are immediately required to comply, and the awaited sector-specific standards, assurance standards, along with national sanctions, introduce questioning. Additionally, there are concerns about the potential for overly lengthy and variability in report content and structure interpretations.

The **current state of ESG integration into EU corporate credit ratings** was also explored, confirming the literature. The level of ESG integration remains inconsistent and variable among EU-registered CRAs. Indeed, while one of the interviewed CRA has developed methodology to incorporate ESG scores into their construction’s assessment, the integration is overall superficial and characterized by a subjective and undefined approach, where ESG factors serve more as secondary background considerations, without affecting the final rating.

The literature suggested that **difficulties in accessing reliable and comparable ESG data were a primary barrier**, our analysis presented a nuanced view, focused on the EU. For small business, literature’s concerns held true. However, for larger corporations, it seems that while such issues are present, the information is sufficient and does not constitute an obstacle for creditworthiness assessments. Nevertheless, the literature is correct regarding the complexity

in assessing the materiality and effects' extent on credit risk of corporations. **Other challenges to ESG integration** were identified, including insufficient internal competencies and tools, insufficient quantitative metrics and a lack of standardized ESG scores methodologies.

Additionally, the thesis brought into light the **distinction of ESG integration level between dominant and smaller EU-registered CRAs**. While the overall level is the same, the scrutiny and demand for transparency is especially concentrated for dominant CRAs, surely because of their influence on the market, and previously historical involvement in crises.

Finally, we explored the **potential opportunities the CSRD could bring for integrating ESG factors into EU corporate credit rating**. Our findings, based on interviewee expectations, suggest that the CSRD would significantly enhance it through improved quality, comparability and availability of corporate extra-financial information. This advancement is expected to be transformative for credit analysts' work, improving credit ratings quality and depth based on robust ESG metrics. The effect is predicted to be particularly pronounced for smaller entities.

2. Final conclusion

Ultimately, the ESG factors integration into corporate credit ratings is both important and necessary. However, practical implementation remains a challenge for CRAs across the EU. The work of EthFinance is a demonstration of a better, yet not flawless, ESG integration methodology that other CRAs could begin adopting. At the end, CRAs find themselves in the same predicament than many other actors in financial markets: the lack of tools and expertise to integrate such considerations. The introduction of the CSRD shows promise in facilitating the ESG factors incorporation into EU corporate credit ratings, but also presents short-term challenges that need to be addressed to fully realize its potential.

To overcome this, innovative analytical tools, research, and artificial intelligence could help better determine ESG materiality in corporate credit risks, and the extent of its effect. Stakeholder engagement is crucial in shaping ESG integration methodologies. The work of the European Securities and Markets Authority (ESMA) in establishing guidelines and standards for ESG integration into credit ratings is pivotal in ensuring that no CRA is left behind.

From a personal perspective, the superficial integration of ESG factors into EU corporate credit ratings reveals a wealth of untapped non-financial information that could substantially improve these evaluations, especially with the anticipated effects of the CSRD. The differing views on sustainability report quality between CSRD or sustainability experts and credit risk analysts

further underscore concerns about current ratings quality and a potential lack of awareness among CRAs' analysts. Ultimately, the responsibility rests with CRAs to effectively harness CSRD's improvements. And a crucial question persists: Will these enhancements be sufficient to meet the demands of investors seeking more thorough and comprehensive ESG-integrated assessments? On an optimistic note, the evolving regulatory environment is promoting increased transparency and accountability, which may lead to more credible ratings. Nonetheless, stakeholders must remain vigilant and proactive in ensuring these changes are fully realized and effective.

3. Limitations

Several limitations must be highlighted in this thesis. First, the presented results are based on the transcription of interviews. While it was conducted meticulously, misinterpretation is possible. Additionally, challenges in meeting the selection criteria were encountered, and no executives or people deeply involved in creditworthiness assessment methodologies in CRAs were interviewed, which may have limited the findings' depth. Therefore, it only focuses on credit analysts and their knowledge and field experience.

Furthermore, this thesis's results are based on expectations of interviewees. Different interviewees might have provided contradictory information, or additional perspectives. Finally, reports under CSRD will only come out in 2025, reporting on the financial year 2024. As such, its actual effects cannot be observed, and only time will confirm or refute our findings. A complementary analysis would have helped us deepen our understanding of the research's topic.

4. Future research

Future research should aim to explore the long-term impacts of the CSRD once fully operational, and how ongoing regulatory developments and market responses will shape the landscape of ESG integration in corporate credit ratings, not only in the EU but also in other continents. Interviewing individuals involved in corporate credit ratings methodologies would enhance the analysis quality further, and will help confirm, specify or contradict current expectations. Investigating tools with the ability to enhance ESG integration into corporate credit ratings in the future would also be insightful. Research could broaden the scope of ratings beyond corporate ones and include all types of ratings. At last, it would also be interesting to explore the effects of the CSRD on ESG ratings, which rely more heavily on extra-financial information than credit ratings do.

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