Course 2022-2023 in Sustainable Finance
Lecture 2. ESG Scoring

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1The opinions expressed in this presentation are those of the authors and are not meant to represent the opinions or official positions of Amundi Asset Management.
Several issues:

- **E**: climate change mitigation, climate change adaptation, preservation of biodiversity, pollution prevention, circular economy
- **S**: inequality, inclusiveness, labor relations, investment in human capital and communities, human rights
- **G**: management structure, employee relations, executive remuneration

⇒ requires a lot of alternative data
Sovereign ESG data

Sovereign ESG framework

- World Bank
- Data may be download at the following webpage: https://datatopics.worldbank.org/esg/framework.html
- **E**: 27 variables
- **S**: 22 variables
- **G**: 18 variables
Table 1: The World Bank database of sovereign ESG indicators

**Environmental**
- Emissions & pollution (5)
- Natural capital endowment and management (6)
- Energy use & security (7)
- Environment/ climate risk & resilience (6)
- Food security (3)

**Social**
- Education & skills (3)
- Employment (3)
- Demography (3)
- Poverty & inequality (4)
- Health & nutrition (5)
- Access to services (4)

**Governance**
- Human rights (2)
- Government effectiveness (2)
- Stability & rule of law (4)
- Economic environment (3)
- Gender (4)
- Innovation (3)
Table 2: Indicators of the environmental pillar (World Bank database)

- **Emissions & pollution**: (1) CO2 emissions (metric tons per capita); (2) GHG net emissions/removals by LUCF (Mt of CO2 equivalent); (3) Methane emissions (metric tons of CO2 equivalent per capita); (4) Nitrous oxide emissions (metric tons of CO2 equivalent per capita); (5) PM2.5 air pollution, mean annual exposure (micrograms per cubic meter);

- **Natural capital endowment & management**: (1) Adjusted savings: natural resources depletion (% of GNI); (2) Adjusted savings: net forest depletion (% of GNI); (3) Annual freshwater withdrawals, total (% of internal resources); (4) Forest area (% of land area); (5) Mammal species, threatened; (6) Terrestrial and marine protected areas (% of total territorial area);

- **Energy use & security**: (1) Electricity production from coal sources (% of total); (2) Energy imports, net (% of energy use); (3) Energy intensity level of primary energy (MJ/$2011 PPP GDP); (4) Energy use (kg of oil equivalent per capita); (5) Fossil fuel energy consumption (% of total); (6) Renewable electricity output (% of total electricity output); (7) Renewable energy consumption (% of total final energy consumption);

- **Environment/climate risk & resilience**: (1) Cooling degree days (projected change in number of degree Celsius); (2) Droughts, floods, extreme temperatures (% of population, average 1990-2009); (3) Heat Index 35 (projected change in days); (4) Maximum 5-day rainfall, 25-year return level (projected change in mm); (5) Mean drought index (projected change, unitless); (6) Population density (people per sq. km of land area)

- **Food security**: (1) Agricultural land (% of land area); (2) Agriculture, forestry, and fishing, value added (% of GDP); (3) Food production index (2004-2006 = 100);

Sovereign ESG data

Table 3: Indicators of the social pillar (World Bank database)

- **Education & skills**: (1) Government expenditure on education, total (% of government expenditure); (2) Literacy rate, adult total (% of people ages 15 and above); (3) School enrollment, primary (% gross);

- **Employment**: (1) Children in employment, total (% of children ages 7-14); (2) Labor force participation rate, total (% of total population ages 15-64) (modeled ILO estimate); (3) Unemployment, total (% of total labor force) (modeled ILO estimate);

- **Demography**: (1) Fertility rate, total (births per woman); (2) Life expectancy at birth, total (years); (3) Population ages 65 and above (% of total population);

- **Poverty & inequality**: (1) Annualized average growth rate in per capita real survey mean consumption or income, total population (%); (2) Gini index (World Bank estimate); (3) Income share held by lowest 20%; (4) Poverty headcount ratio at national poverty lines (% of population);

- **Health & nutrition**: (1) Cause of death, by communicable diseases and maternal, prenatal and nutrition conditions (% of total); (2) Hospital beds (per 1,000 people); (3) Mortality rate, under-5 (per 1,000 live births); (4) Prevalence of overweight (% of adults); (5) Prevalence of undernourishment (% of population);

- **Access to services**: (1) Access to clean fuels and technologies for cooking (% of population); (2) Access to electricity (% of population); (3) People using safely managed drinking water services (% of population); (4) People using safely managed sanitation services (% of population);

Table 4: Indicators of the governance pillar (World Bank database)

- **Human rights**: (1) Strength of legal rights index (0 = weak to 12 = strong); (2) Voice and accountability (estimate);
- **Government effectiveness**: (1) Government effectiveness (estimate); (2) Regulatory quality (estimate);
- **Stability & rule of law**: (1) Control of corruption (estimate); (2) Net migration; (3) Political stability and absence of violence/terrorism (estimate); (4) Rule of law (estimate);
- **Economic environment**: (1) Ease of doing business index (1 = most business-friendly regulations); (2) GDP growth (annual %); (3) Individuals using the internet (% of population);
- **Gender**: (1) Proportion of seats held by women in national parliaments (%); (2) Ratio of female to male labor force participation rate (%) (modeled ILO estimate); (3) School enrollment, primary and secondary (gross), gender parity index (GPI); (4) Unmet need for contraception (% of married women ages 15-49);
- **Innovation**: (1) Patent applications, residents; (2) Research and development expenditure (% of GDP); (3) Scientific and technical journal articles;

Where to find the data?

- National accounts statistics collected by OECD, United Nations Statistics Division (UNSD), etc.
- Internal departments and specialized databases of the World Bank: World Bank Open Data, Business Enabling Environment (BEE), Climate Change Knowledge Portal (CCKP), Global Electrification Database (GEP), etc.
- International organizations: Emission Database for Global Atmospheric Research (EDGAR), Food and Agriculture Organization (FAO), International Energy Agency (IEA), International Labour Organization (ILO), World Health Organization (WHO), etc.
- NGOs: Climate Watch, etc.;
- Academic resources: International disasters database (EM-DAT) of the Centre for Research on the Epidemiology of Disasters (Université Catholique de Louvain), etc.
The most known are FTSE (Beyond Ratings), Moody’s (Vigeo-Eiris), MSCI, Sustainalytics, RepRisk and Verisk Mapplecroft.

⇒ The average cross-correlation between data providers is equal to 85% for the ESG score, 42% for the environmental score, 85% for the social score and 71% for the governance score.
### Table 5: Correlation of ESG scores with country's national income (GNI per capita)

<table>
<thead>
<tr>
<th>Factor</th>
<th>ESG</th>
<th>E</th>
<th>S</th>
<th>G</th>
</tr>
</thead>
<tbody>
<tr>
<td>ISS</td>
<td>68%</td>
<td>7%</td>
<td>86%</td>
<td>77%</td>
</tr>
<tr>
<td>FTSE (Beyond Ratings)</td>
<td>91%</td>
<td>74%</td>
<td>88%</td>
<td>84%</td>
</tr>
<tr>
<td>MSCI</td>
<td>84%</td>
<td>10%</td>
<td>90%</td>
<td>77%</td>
</tr>
<tr>
<td>RepRisk</td>
<td>78%</td>
<td>79%</td>
<td>75%</td>
<td>37%</td>
</tr>
<tr>
<td>RobecoSAM</td>
<td>89%</td>
<td>82%</td>
<td>85%</td>
<td>85%</td>
</tr>
<tr>
<td>Sustainalytics</td>
<td>95%</td>
<td>83%</td>
<td>94%</td>
<td>93%</td>
</tr>
<tr>
<td>V.E</td>
<td>60%</td>
<td>23%</td>
<td>79%</td>
<td>39%</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>81%</strong></td>
<td><strong>51%</strong></td>
<td><strong>85%</strong></td>
<td><strong>70%</strong></td>
</tr>
</tbody>
</table>

Source: Gratcheva et al. (2020).
The mushrooming growth of data

**Figure 1:** Palm oil production (2019)

The mushrooming growth of data

**Figure 2:** Palm oil imports (2019)

The mushrooming growth of data

**Figure 3:** Share of global annual deforestation (2015)

Source: Our World in Data, [https://ourworldindata.org/deforestation](https://ourworldindata.org/deforestation).
The mushrooming growth of data

Figure 4: Threatened mammal species (2018)

Threatened mammal species, 2018
Mammal species are mammals excluding whales and porpoises. Threatened species are those classified on the Red List as Critically Endangered, Endangered or Vulnerable. They are at high or greater risk of extinction in the wild.

An example with the biodiversity risk

Figure 5: Global living planet index

Source: https://livingplanetindex.org/latest_results & Author’s calculation.
An example with the biodiversity risk

Some databases:

- the Red List Index (RLI)
- World Database on Protected Areas (WDPA)
- Integrated Biodiversity Assessment Tool (IBAT)
- Exploring Natural Capital Opportunities, Risks and Exposure (ENCORE)
- Etc.
Corporate ESG data

Data sources:

1. Corporate publications (self-reporting)
   - Annual reports
   - Corporate sustainability reports

2. Financial and regulatory filings (standardized reporting)
   - Mandatory reports (SFDR, CSRD, EUTR, etc.)
   - Non-mandatory frameworks (PRI, TCFD, CDP, etc.)

3. News and other media

4. NGO reports and websites

5. Company assessment and due diligence questionnaire (DDQ)

6. Internal models
Figure 6: From raw data to ESG pillars

Raw data
(or data points)

ESG Metrics

ESG Indicators

ESG Themes

ESG Pillars
Table 6: An example of ESG criteria (corporate issuers)

<table>
<thead>
<tr>
<th>Environmental</th>
<th>Social</th>
<th>Governance</th>
</tr>
</thead>
<tbody>
<tr>
<td>Carbon emissions</td>
<td>Employment conditions</td>
<td>Board independence</td>
</tr>
<tr>
<td>Energy use</td>
<td>Community involvement</td>
<td>Corporate behaviour</td>
</tr>
<tr>
<td>Pollution</td>
<td>Gender equality</td>
<td>Audit and control</td>
</tr>
<tr>
<td>Waste disposal</td>
<td>Diversity</td>
<td>Executive compensation</td>
</tr>
<tr>
<td>Water use</td>
<td>Stakeholder opposition</td>
<td>Shareholder’ rights</td>
</tr>
<tr>
<td>Renewable energy</td>
<td>Access to medicine</td>
<td>CSR strategy</td>
</tr>
<tr>
<td><strong>Green cars</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Green financing</strong></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

(*) means a specific criterion related to one or several sectors
(Green cars ⇒ Automobiles, Green financing ⇒ Financials)
Corporate ESG data

Some examples:

- Bloomberg rates 11,800 public companies. They use more than 120 ESG indicators and 2,000+ data points.
- ISS ESG rates about 10,000 issuers. They use more than 800 indicators and applies approximately 100 indicators per company.
- FTSE Russell rates about 7,200 securities. They use more than 300 indicators and 14 themes.
- MSCI rates 10,000 companies (14,000 issuers including subsidiaries) and 680,000 securities globally. They use 10 themes, 1000+ data points, 80 exposure metrics and 250+ management metrics.
- Refinitiv rates 12,000 public and private companies. They consider 10 themes. These themes are built using 186 metrics and 630+ data points.
- S&P Dow Jones Indices uses between 16 to 27 criteria scores, a questionnaire and 1,000 data points.
- Sustainalytics rates more than 16,300 companies. They consider 20 material ESG issues, based on 350+ indicators.
The race for alternative data

- Controversies ⇒ NLP (RepRisk, daily basis: 500,000+ documents, 100,000+ sources, 23 languages)
- Geospatial data ⇒ Physical risk
The divergence of corporate ESG ratings

Figure 7: ESG rating disagreement

This graph illustrates the ESG rating divergence. The horizontal axis indicates the value of the Sustainalytics rating as a benchmark for each firm ($n=924$). Rating values by the other five raters are plotted on the vertical axis in different colors. For each rater, the distribution of values has been normalized to zero mean and unit variance. The Sustainalytics rating has discrete values that show up visually as vertical lines where several companies have the same rating value.

Source: Berg et al. (2022).
The divergence of corporate ESG ratings

Berg et al. (2022) identify three sources of divergence:

1. **Measurement** divergence refers to situation where rating agencies measure the same indicator using different ESG metrics (56%)

2. **Scope** divergence refers to situation where ratings are based on different set of ESG indicators (38%)

3. **Weight** divergence emerges when rating agencies take different views on the relative importance of ESG indicators” (6%)
The divergence of corporate ESG ratings

Table 7: Rank correlation among ESG ratings

<table>
<thead>
<tr>
<th></th>
<th>MSCI</th>
<th>Refinitiv</th>
<th>S&amp;P Global</th>
</tr>
</thead>
<tbody>
<tr>
<td>MSCI</td>
<td>100%</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Refinitiv</td>
<td>43%</td>
<td>100%</td>
<td></td>
</tr>
<tr>
<td>S&amp;P Global</td>
<td>45%</td>
<td>69%</td>
<td>100%</td>
</tr>
<tr>
<td>Sustainalytics</td>
<td>53%</td>
<td>64%</td>
<td>69%</td>
</tr>
</tbody>
</table>

Source: Billio et al. (2021).
One-level tree structure

- $X_1, \ldots, X_m$ are $m$ features
- The score is linear:
  $$ S = \sum_{j=1}^{m} \omega_j X_j $$
- $\omega_j$ is the weight of the $j^{th}$ metric
One-level tree structure

- $X_1, \ldots, X_m$ are $m$ features
- The score is linear:
  \[ S = \sum_{j=1}^{m} \omega_j X_j \]
- $\omega_j$ is the weight of the $j^{th}$ metric
The Altman $Z$ score is equal to:

$$Z = 1.2 \cdot X_1 + 1.4 \cdot X_2 + 3.3 \cdot X_3 + 0.6 \cdot X_4 + 1.0 \cdot X_5$$

where the variables $X_j$ represent the following financial ratios:

<table>
<thead>
<tr>
<th>$X_j$</th>
<th>Ratio</th>
</tr>
</thead>
<tbody>
<tr>
<td>$X_1$</td>
<td>Working capital / Total assets</td>
</tr>
<tr>
<td>$X_2$</td>
<td>Retained earnings / Total assets</td>
</tr>
<tr>
<td>$X_3$</td>
<td>Earnings before interest and tax / Total assets</td>
</tr>
<tr>
<td>$X_4$</td>
<td>Market value of equity / Total liabilities</td>
</tr>
<tr>
<td>$X_5$</td>
<td>Sales / Total assets</td>
</tr>
</tbody>
</table>

$$Z_i \Rightarrow Z_i^* = \left( Z_i - m_z \right) / \sigma_z \Rightarrow \text{Decision rule}$$
The intermediary scores are equal to:

\[ S_{k}^{(1)} = \sum_{j=1}^{m} \omega_{j,k}^{(1)} X_j \]

whereas the expression of the final score is:

\[ S := S_1^{(0)} = \sum_{k=1}^{m(1)} \omega_k^{(0)} S_k^{(1)} \]
Figure 8: A two-level non-overlapping tree

- Level 1: $\omega_{1,1}^{(1)} = 50\%; \omega_{2,1}^{(1)} = 25\%; \omega_{3,1}^{(1)} = 25\%; \omega_{4,2}^{(1)} = 50\%; \omega_{5,2}^{(1)} = 50\%; \omega_{6,3}^{(1)} = 100\%$;
- Level 0: $\omega_{1}^{(0)} = \omega_{2}^{(0)} = \omega_{3}^{(0)} = 33.33\%$;
Two-level tree structure

\[
\begin{align*}
S_1^{(1)} &= 0.5 \cdot X_1 + 0.25 \cdot X_2 + 0.25 \cdot X_3 \\
S_2^{(1)} &= 0.5 \cdot X_4 + 0.5 \cdot X_5 \\
S_3^{(1)} &= X_6
\end{align*}
\]

\[
S = \frac{S_1^{(1)} + S_2^{(1)} + S_3^{(1)}}{3}
\]
Two-level tree structure

Figure 9: A two-level overlapping tree graph

- Level 1: \( \omega_{1,1}^{(1)} = 50\%; \omega_{2,1}^{(1)} = 25\%; \omega_{3,1}^{(1)} = 25\%; \omega_{3,2}^{(1)} = 25\%; \omega_{4,2}^{(1)} = 25\%; \omega_{5,2}^{(1)} = 50\%; \omega_{6,3}^{(1)} = 100\% \)
- Level 0: \( \omega_{1}^{(0)} = \omega_{2}^{(0)} = \omega_{3}^{(0)} = 33.33\% \)
Figure 10: Tree data structure
- $L$ is the number of levels
- We have $S_j^{(L)} = X_j$
- The value of the $k^{th}$ node at level $\ell$ is given by:

$$S_k^{(\ell)} = \sum_{j=1}^{m(\ell+1)} \omega_{j,k} S_j^{(\ell+1)}$$
Figure 11: An example of ESG scoring tree (MSCI methodology)

Source: MSCI (2020)
Let $\omega(\ell)$ be the $m(\ell+1) \times m(\ell)$ matrix, whose elements are $\omega_{j,k}^{(\ell)}$ for $j = 1, \ldots, m(\ell+1)$ and $k = 1, \ldots, m(\ell)$.

The final score is equal to:

$$S = \omega^\top X$$

where:

$$\omega = \omega_{L-1} \cdots \omega(1) \omega(0)$$
If $X \sim F$, we obtain:

$$G(s) = \Pr \{ S \leq s \} = \Pr \{ \omega^\top X \leq s \}$$

$$= \int \cdots \int 1 \{ \omega^\top x \leq s \} \, dF(x)$$

$$= \int \cdots \int 1 \left\{ \sum_{j=1}^{m} \omega_j x_j \leq s \right\} \, dF(x_1, \ldots, x_m)$$

$$= \int \cdots \int 1 \left\{ \sum_{j=1}^{m} \omega_j x_j \leq s \right\} \, dC(F_1(x_1), \ldots, F_m(x_m))$$

Therefore, the distribution $G$ depends on the copula function $C$ and the marginals $(F_1, \ldots, F_m)$ of $F$.

$$F_1 \equiv F_1 \equiv \ldots \equiv F_m \Rightarrow G \equiv F_1 ?$$
In the independent case, we obtain a convolution probability distribution:

\[
G(s) = \int \cdots \int \mathbb{1} \left\{ \sum_{j=1}^{m} \omega_j x_j \leq s \right\} \prod_{j=1}^{m} dF_j(x_j)
\]

If \( X_j \sim \mathcal{N} (\mu_j, \sigma_j^2) \), we have \( \omega_j X_j \sim \mathcal{N} (\omega_j \mu_j, \omega_j^2 \sigma_j^2) \). We deduce that:

\[
S \sim \mathcal{N} \left( \sum_{j=1}^{m} \omega_j \mu_j, \sum_{j=1}^{m} \omega_j^2 \sigma_j^2 \right) \equiv \mathcal{N} (\omega^\top \mu, \omega^\top \Sigma \omega)
\]

where \( \mu = (\mu_1, \ldots, \mu_m) \) and \( \Sigma = \text{diag} (\sigma_1^2, \ldots, \sigma_m^2) \).
Score normalization

Figure 12: Probability distribution of the scores based on the previous tree
Exercise

We assume that $X_1 \sim U_{[0,1]}$ and $X_2 \sim U_{[0,1]}$ are two independent random variables. We consider the score $S$ defined as:

$$S = \frac{X_1 + X_2}{2}$$
Figure 13: Geometric interpretation of the probability mass function

Case (a): $0 \leq s \leq 0.5$

Case (b): $0.5 \leq s \leq 1$
We deduce that:

\[
\Pr\{\mathcal{S} \leq s\} = \begin{cases} 
\frac{1}{2} (2s)^2 = 2s^2 & \text{if } 0 \leq s \leq \frac{1}{2} \\
1 - \frac{1}{2} (2 - 2s)^2 = -1 + 4s - 2s^2 & \text{if } \frac{1}{2} \leq s \leq 1 
\end{cases}
\]

The density function is then:

\[
g(s) = \begin{cases} 
4s & \text{if } 0 \leq s \leq \frac{1}{2} \\
4 - 4s & \text{if } \frac{1}{2} \leq s \leq 1 
\end{cases}
\]

In the general case, we have:

\[
\mathcal{S} = \frac{\sum X_1 + X_2 + \cdots + X_m}{m} \sim \text{Bates}(m)
\]
Figure 14: Probability density function of $S$ (uniform distribution)
Exercise

We assume that $X \sim \mathcal{N}(\mu, \Sigma)$ with $\mu_j = 0$, $\sigma_j = 1$ and $\rho_{j,k} = \rho$ for $j \neq k$. Show that:

$$\mathbb{E}[S] = 0$$

and

$$\text{var}(S) = \rho S^2(w) + (1 - \rho) \mathcal{H}(\omega)$$

where $S(w) = \sum_{j=1}^{m} \omega_j$ is the sum index and $\mathcal{H}(\omega) = \sum_{j=1}^{m} \omega_j^2$ is the Herfindahl index. Deduce that:

$$\sigma_S = \sqrt{\rho + (1 - \rho) \mathcal{H}(\omega)}$$
Score normalization

How to normalize?

\[ S_k^{(\ell)} = \varphi \left( \sum_{j=1}^{m(\ell+1)} \omega_{j,k} S_j^{(\ell+1)} \right) \]
Score normalization

1. **m-score normalization:**

\[ m_i = \frac{x_i - x^-}{x^+ - x^-} \]

where \( x^- = \min x_i \) and \( x^+ = \max x_i \)

2. **q-score normalization:**

\[ q_i = H(x_i) \]

where \( H \) is the distribution function of \( X \)

3. **z-score normalization:**

\[ z_i = \frac{x_i - \mu}{\sigma} \]

where \( \mu \) and \( \sigma \) are the mathematical expectation and standard deviation of \( X \)

4. **b-score normalization:**

\[ b_i = B^{-1}(H(x_i); \alpha, \beta) \]

where \( B(\alpha, \beta) \) is the beta distribution
Score normalization

Probability integral transform (PIT)

If $X \sim H$ and is continuous, $Y = H(X)$ is a uniform random variable.

We have $Y \in [0, 1]$ and:

$$\Pr \{ Y \leq y \} = \Pr \{ H(X) \leq y \}$$
$$= \Pr \{ X \leq H^{-1}(y) \}$$
$$= H(H^{-1}(y))$$
$$= y$$
Score normalization

Computing the empirical distribution $\hat{H}$

- Let $\{x_1, x_2, \ldots, x_n\}$ be the sample
- We have:

$$q_i = \hat{H}(x_i) = \Pr\{X \leq x_i\} = \frac{\# \{x_j \leq x_i\}}{n_q}$$

- $n_q = n$ or $n_q = n + 1$?
Score normalization

Exercise

What is the normalization shape of this transformation?

\[ S = \frac{2}{1 + e^{-z}} - 1 \]

Hint: compute the density function.
Score normalization

Example

The data are normally distributed with mean $\mu = 5$ and standard deviation $\sigma = 2$. To map these data into a 0/1 score, we consider the following transform:

$$s := \varphi(x) = \mathcal{B}^{-1} \left( \Phi \left( \frac{x - 5}{2} \right); \alpha, \beta \right)$$
Score normalization

Figure 15: Transforming data into $b$-score

Transform function $s = \varphi(x)$

- $\alpha = \beta = 2$
- $\alpha = \beta = 7$
- $\alpha = 2.5$, $\beta = 1.5$

Probability density function of the score
Score normalization

Example

We consider the raw data of 9 companies that belong to the same industry. The first variable measures the carbon intensity of the scope 1 + 2 in 2020, while the second variable is the variation of carbon emissions between 2015 and 2020. We would like to create the score $S \equiv 70\% \cdot X_1 + 30\% \cdot X_2$.

<table>
<thead>
<tr>
<th>Firm</th>
<th>Carbon intensity in tCO$_2$e/$ mn)</th>
<th>Carbon momentum (in %)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>94.0</td>
<td>-3.0</td>
</tr>
<tr>
<td>2</td>
<td>38.6</td>
<td>-5.5</td>
</tr>
<tr>
<td>3</td>
<td>30.6</td>
<td>5.6</td>
</tr>
<tr>
<td>4</td>
<td>74.4</td>
<td>-1.3</td>
</tr>
<tr>
<td>5</td>
<td>97.1</td>
<td>-16.8</td>
</tr>
<tr>
<td>6</td>
<td>57.1</td>
<td>-3.5</td>
</tr>
<tr>
<td>7</td>
<td>132.4</td>
<td>8.5</td>
</tr>
<tr>
<td>8</td>
<td>92.5</td>
<td>-9.1</td>
</tr>
<tr>
<td>9</td>
<td>64.9</td>
<td>-4.6</td>
</tr>
</tbody>
</table>
Score normalization

- *q*-score 0/100
- *z*-score
- \( qz = 100 \cdot \Phi(z) \)
- \( zq = \Phi^{-1}\left(\frac{q}{100}\right) \)
- \( bz = \mathcal{B}^{-1}(\Phi(z); \alpha, \beta) \) where \( \alpha = \beta = 2 \)
- \( bz^* = \mathcal{B}^{-1}(\Phi(z); \alpha, \beta) \) where \( \alpha = 2.5 \) and \( \beta = 1.5 \).
### Table 8: Computation of the score $S \equiv 70\% \cdot X_1 + 30\% \cdot X_2$ (q-score 0/100 normalization)

<table>
<thead>
<tr>
<th>#</th>
<th>$X_1$</th>
<th>$q_1$</th>
<th>$X_2$</th>
<th>$q_2$</th>
<th>$s$</th>
<th>$S$</th>
<th>$\Delta$</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>94.00</td>
<td>70.00</td>
<td>–3.00</td>
<td>60.00</td>
<td>67.00</td>
<td>80.00</td>
<td>8</td>
</tr>
<tr>
<td>2</td>
<td>38.60</td>
<td>20.00</td>
<td>–5.50</td>
<td>30.00</td>
<td>23.00</td>
<td>10.00</td>
<td>1</td>
</tr>
<tr>
<td>3</td>
<td>30.60</td>
<td>10.00</td>
<td>5.60</td>
<td>80.00</td>
<td>31.00</td>
<td>20.00</td>
<td>2</td>
</tr>
<tr>
<td>4</td>
<td>74.40</td>
<td>50.00</td>
<td>–1.30</td>
<td>70.00</td>
<td>56.00</td>
<td>60.00</td>
<td>6</td>
</tr>
<tr>
<td>5</td>
<td>97.10</td>
<td>80.00</td>
<td>–16.80</td>
<td>10.00</td>
<td>59.00</td>
<td>70.00</td>
<td>7</td>
</tr>
<tr>
<td>6</td>
<td>57.10</td>
<td>30.00</td>
<td>–3.50</td>
<td>50.00</td>
<td>36.00</td>
<td>30.00</td>
<td>3</td>
</tr>
<tr>
<td>7</td>
<td>132.40</td>
<td>90.00</td>
<td>8.50</td>
<td>90.00</td>
<td>90.00</td>
<td>90.00</td>
<td>9</td>
</tr>
<tr>
<td>8</td>
<td>92.50</td>
<td>60.00</td>
<td>–9.10</td>
<td>20.00</td>
<td>48.00</td>
<td>50.00</td>
<td>5</td>
</tr>
<tr>
<td>9</td>
<td>64.90</td>
<td>40.00</td>
<td>–4.60</td>
<td>40.00</td>
<td>40.00</td>
<td>40.00</td>
<td>4</td>
</tr>
<tr>
<td>Mean</td>
<td>75.73</td>
<td>50.00</td>
<td>–3.30</td>
<td>50.00</td>
<td>50.00</td>
<td>50.00</td>
<td>5</td>
</tr>
<tr>
<td>Std-dev.</td>
<td>31.95</td>
<td>27.39</td>
<td>7.46</td>
<td>27.39</td>
<td>20.60</td>
<td>27.39</td>
<td>4</td>
</tr>
</tbody>
</table>
Score normalization

### Table 9: Computation of the score $S = 70\% \cdot X_1 + 30\% \cdot X_2$ (z-score normalization)

<table>
<thead>
<tr>
<th>#</th>
<th>$X_1$</th>
<th>$z_1$</th>
<th>$X_2$</th>
<th>$z_2$</th>
<th>$s$</th>
<th>$S$</th>
<th>$\mathcal{N}$</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>94.00</td>
<td>0.572</td>
<td>-3.00</td>
<td>0.040</td>
<td>0.412</td>
<td>0.543</td>
<td>8</td>
</tr>
<tr>
<td>2</td>
<td>38.60</td>
<td>-1.162</td>
<td>-5.50</td>
<td>-0.295</td>
<td>-0.902</td>
<td>-1.188</td>
<td>1</td>
</tr>
<tr>
<td>3</td>
<td>30.60</td>
<td>-1.413</td>
<td>5.60</td>
<td>1.193</td>
<td>-0.631</td>
<td>-0.831</td>
<td>2</td>
</tr>
<tr>
<td>4</td>
<td>74.40</td>
<td>-0.042</td>
<td>-1.30</td>
<td>0.268</td>
<td>0.051</td>
<td>0.067</td>
<td>6</td>
</tr>
<tr>
<td>5</td>
<td>97.10</td>
<td>0.669</td>
<td>-16.80</td>
<td>-1.810</td>
<td>-0.075</td>
<td>-0.099</td>
<td>5</td>
</tr>
<tr>
<td>6</td>
<td>57.10</td>
<td>-0.583</td>
<td>-3.50</td>
<td>-0.027</td>
<td>-0.416</td>
<td>-0.548</td>
<td>3</td>
</tr>
<tr>
<td>7</td>
<td>132.40</td>
<td>1.774</td>
<td>8.50</td>
<td>1.582</td>
<td>1.716</td>
<td>2.261</td>
<td>9</td>
</tr>
<tr>
<td>8</td>
<td>92.50</td>
<td>0.525</td>
<td>-9.10</td>
<td>-0.778</td>
<td>0.134</td>
<td>0.177</td>
<td>7</td>
</tr>
<tr>
<td>9</td>
<td>64.90</td>
<td>-0.339</td>
<td>-4.60</td>
<td>-0.174</td>
<td>-0.290</td>
<td>-0.382</td>
<td>4</td>
</tr>
<tr>
<td>Mean</td>
<td>75.73</td>
<td>0.000</td>
<td>-3.30</td>
<td>0.000</td>
<td>0.000</td>
<td>0.000</td>
<td></td>
</tr>
<tr>
<td>Std-dev.</td>
<td>31.95</td>
<td>1.000</td>
<td>7.46</td>
<td>1.000</td>
<td>0.759</td>
<td>1.000</td>
<td></td>
</tr>
</tbody>
</table>
### Table 10: Comparison of the different scoring methods

<table>
<thead>
<tr>
<th>#</th>
<th>( q )</th>
<th>( z )</th>
<th>( qz )</th>
<th>( zq )</th>
<th>( bz )</th>
<th>( bz^* )</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>80.00</td>
<td>0.54</td>
<td>76.27</td>
<td>0.84</td>
<td>0.66</td>
<td>0.81</td>
</tr>
<tr>
<td>2</td>
<td>10.00</td>
<td>−1.19</td>
<td>9.19</td>
<td>−1.28</td>
<td>0.20</td>
<td>0.30</td>
</tr>
<tr>
<td>3</td>
<td>20.00</td>
<td>−0.83</td>
<td>21.37</td>
<td>−0.84</td>
<td>0.29</td>
<td>0.38</td>
</tr>
<tr>
<td>4</td>
<td>60.00</td>
<td>0.07</td>
<td>54.13</td>
<td>0.25</td>
<td>0.52</td>
<td>0.70</td>
</tr>
<tr>
<td>5</td>
<td>70.00</td>
<td>−0.10</td>
<td>56.65</td>
<td>0.52</td>
<td>0.51</td>
<td>0.64</td>
</tr>
<tr>
<td>6</td>
<td>30.00</td>
<td>−0.55</td>
<td>24.42</td>
<td>−0.52</td>
<td>0.34</td>
<td>0.50</td>
</tr>
<tr>
<td>7</td>
<td>90.00</td>
<td>2.26</td>
<td>98.04</td>
<td>1.28</td>
<td>0.93</td>
<td>0.96</td>
</tr>
<tr>
<td>8</td>
<td>50.00</td>
<td>0.18</td>
<td>60.39</td>
<td>0.00</td>
<td>0.56</td>
<td>0.72</td>
</tr>
<tr>
<td>9</td>
<td>40.00</td>
<td>−0.38</td>
<td>30.96</td>
<td>−0.25</td>
<td>0.39</td>
<td>0.56</td>
</tr>
<tr>
<td>Mean</td>
<td>50.00</td>
<td>0.00</td>
<td>47.94</td>
<td>0.00</td>
<td>0.49</td>
<td>0.62</td>
</tr>
<tr>
<td>Std-dev.</td>
<td>27.39</td>
<td>1.00</td>
<td>28.79</td>
<td>0.82</td>
<td>0.22</td>
<td>0.21</td>
</tr>
</tbody>
</table>
The CEO pay ratio is calculated by dividing the CEO’s compensation by the pay of the median employee. It is one of the key metrics for the G pillar. It has been imposed by the Dodd-Frank Act, which requires that publicly traded companies disclose:

1. the median total annual compensation of all employees other than the CEO;
2. the ratio of the CEO’s annual total compensation to that of the median employee;
3. the wage ratio of the CEO to the median employee.

⇒ the average S&P 500 company’s CEO-to-worker pay ratio was 324-to-1 in 2021 (AFL-CIO)
An example with the CEO pay ratio

Table 11: Examples of CEO pay ratio (June 2021)

<table>
<thead>
<tr>
<th>Company name</th>
<th>P</th>
<th>R</th>
<th>Company name</th>
<th>P</th>
<th>R</th>
</tr>
</thead>
<tbody>
<tr>
<td>Abercrombie &amp; Fitch</td>
<td>1954</td>
<td>4,293</td>
<td>Netflix</td>
<td>202 931</td>
<td>190</td>
</tr>
<tr>
<td>McDonald’s</td>
<td>9 291</td>
<td>1,939</td>
<td>BlackRock</td>
<td>133 644</td>
<td>182</td>
</tr>
<tr>
<td>Coca-Cola</td>
<td>11 285</td>
<td>1,657</td>
<td>Pfizer</td>
<td>98 972</td>
<td>181</td>
</tr>
<tr>
<td>Gap</td>
<td>6 177</td>
<td>1,558</td>
<td>Goldman Sachs</td>
<td>138 854</td>
<td>178</td>
</tr>
<tr>
<td>Alphabet</td>
<td>258 708</td>
<td>1,085</td>
<td>MSCI</td>
<td>55 857</td>
<td>165</td>
</tr>
<tr>
<td>Walmart</td>
<td>22 484</td>
<td>983</td>
<td>Verisk Analytics</td>
<td>77 055</td>
<td>117</td>
</tr>
<tr>
<td>Estee Lauder</td>
<td>30 733</td>
<td>697</td>
<td>Facebook</td>
<td>247 883</td>
<td>94</td>
</tr>
<tr>
<td>Ralph Lauren</td>
<td>21 358</td>
<td>570</td>
<td>Invesco</td>
<td>125 282</td>
<td>92</td>
</tr>
<tr>
<td>NIKE</td>
<td>25 386</td>
<td>550</td>
<td>Boeing</td>
<td>158 869</td>
<td>90</td>
</tr>
<tr>
<td>Citigroup</td>
<td>52 988</td>
<td>482</td>
<td>Citrix Systems</td>
<td>181 769</td>
<td>80</td>
</tr>
<tr>
<td>PepsiCo</td>
<td>45 896</td>
<td>368</td>
<td>Harley-Davidson</td>
<td>187 157</td>
<td>59</td>
</tr>
<tr>
<td>Microsoft</td>
<td>172 512</td>
<td>249</td>
<td>Amazon.com</td>
<td>28 848</td>
<td>58</td>
</tr>
<tr>
<td>Apple</td>
<td>57 596</td>
<td>201</td>
<td>Berkshire Hathaway</td>
<td>65 740</td>
<td>6</td>
</tr>
</tbody>
</table>

Source: https://aflcio.org (June 2021)
An example with the CEO pay ratio

**Figure 16**: Histogram of the CEO pay ratio
An example with the CEO pay ratio

Figure 17: Histogram of $z$-score applied to the CEO pay ratio
An example with the CEO pay ratio

What is the solution? Give the transform function $y = \varphi(x)$.

Hint: use the beta distribution.
Other statistical methods

Unsupervised learning

- Clustering ($K$-means, hierarchical clustering)
- Dimension reduction (PCA, NMF)
Supervised learning

- Discriminant analysis (LDA, QDA)
- Binary choice models (logistic regression, probit model)
- Regression models (OLS, lasso)

⇒ Advanced learning models (k-NN, neural networks and support vector machines) are not relevant in the case of ESG scoring

We need to define the response variable $Y$
Example with credit scoring models

- Let $S_i(t)$ be the credit score of individual $i$ at time $t$
- We have:
  \[
  Y_i(t) = 1 \{ \tau_i \leq t + \delta \} = 1 \{ D_i(t + \delta) = 1 \}
  \]
  where $\tau_i$ and $D_i$ are the default time and the default indicator function, and $\delta$ is the time horizon (e.g., one year)
- The calibration problem of the credit scoring model is:
  \[
  \Pr \{ Y_i(t) = 0 \} = f(S_i(t))
  \]
  where $f$ is an increasing function
Application to ESG scoring models

- Let $S_i(t)$ be the ESG score of company $i$ at time $t$
- **Endogenous response variable:**
  - (a) Best-in-class oriented scoring system:
    \[ Y_i(t) = \mathbb{1} \{ S_i(t + h) \geq s^* \} \]
    where $s^*$ is the best-in-class threshold
  - (b) Worst-in-class oriented scoring system:
    \[ Y_i(t) = \mathbb{1} \{ S_i(t + h) \leq s^* \} \]
    where $s^*$ is the worst-in-class threshold
- **Exogenous response variable**
  - (c) Binary response:
    \[ Y_i(t) = \mathbb{1} \{ C_i(t + h) \geq 0 \} \]
    where $C_i(t)$ is the controversy index
  - (d) Continuous response:
    \[ Y_i(t) = C_i(t + h) \]
- The calibration problem of the ESG scoring model is
  \[ \Pr \{ Y_i(t) = 0 \} = f(S_i(t)) \] or \[ Y_i(t) = f(S_i(t)) \]
  where the function $f$ is increasing for case (a) and decreasing for cases (b), (c) and (d)
Performance evaluation criteria

- ESG scoring and rating
  - Shannon entropy
  - Confusion matrix
  - Binary classification ratios (TPR, FNR, TNR, FPR, PPV, ACC, $F_1$)
- ESG scoring
  - Performance, selection and discriminant curves
  - ROC curve
  - Gini coefficient
### Table 12: Credit rating system of S&P, Moody’s and Fitch

<table>
<thead>
<tr>
<th></th>
<th>Prime</th>
<th>High Grade</th>
<th>Upper</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Safety</td>
<td>Quality</td>
<td>Grade</td>
</tr>
<tr>
<td>S&amp;P/Fitch</td>
<td>AAA</td>
<td>AA+ AA AA-</td>
<td>A+ A A-</td>
</tr>
<tr>
<td>Moody’s</td>
<td>Aaa</td>
<td>Aa1 Aa2 Aa3</td>
<td>A1 A2 A3</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th></th>
<th>Lower</th>
<th>Non Investment</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Grade</td>
<td>Speculative</td>
</tr>
<tr>
<td>S&amp;P/Fitch</td>
<td>BBB+</td>
<td>BB+ BB BB-</td>
</tr>
<tr>
<td>Moody’s</td>
<td>Baa1</td>
<td>Ba1 Ba2 Ba3</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th></th>
<th>Highly</th>
<th>Substantial</th>
<th>In Poor</th>
<th>Extremely</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Speculative</td>
<td>Risk</td>
<td>Standing</td>
<td>Speculative</td>
</tr>
<tr>
<td>S&amp;P/Fitch</td>
<td>B+ B B-</td>
<td>CCC+</td>
<td>CCC CCC-</td>
<td>CC</td>
</tr>
<tr>
<td>Moody’s</td>
<td>B1 B2 B3</td>
<td>Caa1</td>
<td>Caa2 Caa3</td>
<td>Ca</td>
</tr>
</tbody>
</table>
- Amundi: A (high), B, ... to G (low) — 7-grade scale
- FTSE Russell: 0 (low), 1, ... to 5 (high) — 6-grade scale
- ISS ESG: 1 (high), 2, ... to 10 (low) — 10-grade scale
- MSCI: AAA (high), AA, ... to CCC (low) — 7-grade scale
- Refinitiv: A+ (high), A, A-, B+, ... to D- (low) — 12-grade scale
- RepRisk: AAA (high), AA, ... to D (low) — 8-grade scale
- Sustainalytics: 1 (low), 2, ... to 5 (high) — 5-grade scale
ESG rating process

Figure 18: From ESG score to ESG rating

Two-step approach:

1. Specification of the map function:

   \[ \text{Map} : \Omega_S \rightarrow \Omega_R \]
   \[ S \mapsto R = \text{Map}(S) \]

   where \( \Omega_S \) is the support of ESG scores, \( \Omega_R \) is the ordered state space of ESG ratings and \( R \) is the ESG rating.

2. Validation (and the possible forcing) of the rating by the analyst.
Example with the MSCI ESG rating system

- $\Omega_s = [0, 10]$
- $\Omega_R = \{\text{CCC, B, BB, BBB, A, AA, AAA}\}$
- The map function is defined as

$$
\text{Map}(s) = \begin{cases} 
\text{CCC} & \text{if } S \in [0, \frac{10}{7}] \\
\text{B} & \text{if } S \in [\frac{10}{7}, \frac{20}{7}] \\
\text{BB} & \text{if } S \in [\frac{20}{7}, \frac{30}{7}] \\
\text{BBB} & \text{if } S \in [\frac{30}{7}, \frac{40}{7}] \\
\text{A} & \text{if } S \in [\frac{40}{7}, \frac{50}{7}] \\
\text{AA} & \text{if } S \in [\frac{50}{7}, \frac{60}{7}] \\
\text{AAA} & \text{if } S \in [\frac{60}{7}, 10] 
\end{cases}
$$

- $0 - 1.429$
- $1.429 - 2.857$
- $2.857 - 4.286$
- $4.286 - 5.714$
- $5.714 - 7.143$
- $7.143 - 8.571$
- $8.571 - 10$
ESG rating process

- The map function is an increasing piecewise function
- $S \sim F$ and $S \in (s^-, s^+)$
- $\{s_0^*, s_1^*, \ldots, s_{K-1}^*, s_K^* = s^+\}$ are the knots of the piecewise function
- $\Omega_R = \{R_1, \ldots, R_K\}$ is the set of grades

$\Rightarrow$ The frequency distribution of the ratings is given by:

$$p_k = \Pr \{ R = R_k \}$$

$$= \Pr \{ s_{k-1}^* \leq S < s_k^* \}$$

$$= F(s_k^*) - F(s_{k-1}^*)$$
ESG rating process

If we would like to build a rating system with pre-defined frequencies \((p_1, \ldots, p_K)\), we have to solve the following equation:

\[
F(s_k^*) - F(s_{k-1}^*) = p_k
\]

We deduce that:

\[
F(s_k^*) = p_k + F(s_{k-1}^*)
\]

\[
= p_k + p_{k-1} + F(s_{k-2}^*)
\]

\[
= \left( \sum_{j=1}^{k} p_j \right) + F(s_0^*)
\]

and:

\[
s_k^* = F^{-1} \left( \sum_{j=1}^{k} p_j \right)
\]
Exercise

- We assume that $S \sim U[a,b]$
- Show that $p_k = K^{-1}$ if the rating system consists in $K$ equally-sized intervals
- Show that the knots of the map function are equal to:

$$s^*_k = a + (b - a) \left( \sum_{j=1}^{k} p_j \right)$$

when we impose pre-defined frequencies $(p_1, \ldots, p_K)$

- If we consider a 0/100 uniform score and $\Omega_R \times P = (\text{CCC}, 5\%) , (\text{B}, 10\%) , (\text{BB}, 20\%) , (\text{BBB}, 30\%) , (\text{A}, 20\%) , (\text{AA}, 10\%) , (\text{AAA}, 5\%)$, show that $s^*_\text{CCC} = 5$, $s^*_\text{B} = 15$, $s^*_\text{BB} = 35$, $s^*_\text{BBB} = 65$, $s^*_\text{A} = 85$ and $s^*_\text{AA} = 95$
For a $z$-score system ($\mathbf{S} \sim \mathcal{N}(0, 1)$), we obtain:

$$p_k = \Phi(s^*_k) - \Phi(s^*_{k-1})$$
ESG rating process

Figure 19: Map function of a $z$-score (equal-space ratings)

$z = -2.5$, $-1.5$, $-0.5$, $0.5$, $1.5$, $2.5$

- **CCC**: 0.62%
- **B**: 6.06%
- **BB**: 24.17%
- **BBB**: 38.29%
- **A**: 24.17%
- **AA**: 6.06%
- **AAA**: 0.62%
ESG rating process

Figure 20: Map function of a $z$-score (equal-frequency ratings)

$z = -1.0676$  $-0.57$  $-0.18$  $0.18$  $0.57$  $1.0676$
Table 13: ESG migration matrix

<table>
<thead>
<tr>
<th></th>
<th>AAA</th>
<th>AA</th>
<th>A</th>
<th>BBB</th>
<th>BB</th>
<th>B</th>
<th>CCC</th>
</tr>
</thead>
<tbody>
<tr>
<td>AAA</td>
<td>14.3%</td>
<td>14.3%</td>
<td>14.3%</td>
<td>14.3%</td>
<td>14.3%</td>
<td>14.3%</td>
<td>14.3%</td>
</tr>
<tr>
<td>AA</td>
<td>14.3%</td>
<td>14.3%</td>
<td>14.3%</td>
<td>14.3%</td>
<td>14.3%</td>
<td>14.3%</td>
<td>14.3%</td>
</tr>
<tr>
<td>A</td>
<td>14.3%</td>
<td>14.3%</td>
<td>14.3%</td>
<td>14.3%</td>
<td>14.3%</td>
<td>14.3%</td>
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</tr>
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<tr>
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<tr>
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</tr>
<tr>
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<td>14.3%</td>
</tr>
</tbody>
</table>

⇒ \( I(\mathcal{R}(t) | \mathcal{R}(s)) = \ln 7 \)
Table 14: ESG migration matrix

<table>
<thead>
<tr>
<th></th>
<th>AAA</th>
<th>AA</th>
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<th>BBB</th>
<th>BB</th>
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</tr>
<tr>
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<td>0%</td>
<td>0%</td>
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</tr>
<tr>
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<td>100%</td>
<td>0%</td>
<td>0%</td>
<td>0%</td>
<td>0%</td>
</tr>
<tr>
<td>BBB</td>
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<td>0%</td>
<td>0%</td>
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</tr>
<tr>
<td>BB</td>
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<td>B</td>
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<td>100%</td>
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</tr>
<tr>
<td>CCC</td>
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<td>0%</td>
<td>0%</td>
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<td>100%</td>
</tr>
</tbody>
</table>

\[ \Rightarrow I(R(t) \mid R(s)) = 0 \]
### Table 15: ESG migration matrix

<table>
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<th></th>
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<td>0%</td>
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<td>96%</td>
<td>2%</td>
<td>0%</td>
<td>0%</td>
<td>0%</td>
<td>0%</td>
</tr>
<tr>
<td>A</td>
<td>0%</td>
<td>2%</td>
<td>96%</td>
<td>2%</td>
<td>0%</td>
<td>0%</td>
<td>0%</td>
</tr>
<tr>
<td>BBB</td>
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<td>0%</td>
<td>2%</td>
<td>96%</td>
<td>2%</td>
<td>0%</td>
<td>0%</td>
</tr>
<tr>
<td>BB</td>
<td>0%</td>
<td>0%</td>
<td>0%</td>
<td>2%</td>
<td>96%</td>
<td>2%</td>
<td>0%</td>
</tr>
<tr>
<td>B</td>
<td>0%</td>
<td>0%</td>
<td>0%</td>
<td>0%</td>
<td>2%</td>
<td>96%</td>
<td>2%</td>
</tr>
<tr>
<td>CCC</td>
<td>0%</td>
<td>0%</td>
<td>0%</td>
<td>0%</td>
<td>0%</td>
<td>4%</td>
<td>96%</td>
</tr>
</tbody>
</table>

$$0 < I(\mathcal{R}(t) \mid \mathcal{R}(s)) \ll \ln 7$$
A good reference on Markov chains is:

**Norris, J. R. (1997).**

*Markov Chains.*

Rating migration matrix
Discrete time modeling

Definition

- \( \mathcal{R} \) is a time-homogeneous Markov chain
- \( \Omega_{\mathcal{R}} = \{ R_1, \ldots, R_K \} \) is the state space of the chain
- \( \mathbb{K} = \{ 1, \ldots, K \} \) is the corresponding index set
- The transition matrix is defined as \( P = (p_{i,j}) \)
- \( p_{i,j} \) is the probability that the entity migrates from rating \( R_i \) to rating \( R_j \)
- The matrix \( P \) satisfies the following properties:
  - \( \forall i, j \in \mathbb{K}, \ p_{i,j} \geq 0 \)
  - \( \forall i \in \mathbb{K}, \ \sum_{j=1}^{K} p_{i,j} = 1 \)
### Table 16: ESG migration matrix #1 (one-year transition probability in %)

<table>
<thead>
<tr>
<th></th>
<th>AAA</th>
<th>AA</th>
<th>A</th>
<th>BBB</th>
<th>BB</th>
<th>B</th>
<th>CCC</th>
</tr>
</thead>
<tbody>
<tr>
<td>AAA</td>
<td>92.76</td>
<td>5.66</td>
<td>0.90</td>
<td>0.45</td>
<td>0.23</td>
<td>0.00</td>
<td>0.00</td>
</tr>
<tr>
<td>AA</td>
<td>4.15</td>
<td>82.73</td>
<td>11.86</td>
<td>0.89</td>
<td>0.30</td>
<td>0.07</td>
<td>0.00</td>
</tr>
<tr>
<td>A</td>
<td>0.18</td>
<td>15.47</td>
<td>72.98</td>
<td>10.46</td>
<td>0.82</td>
<td>0.09</td>
<td>0.00</td>
</tr>
<tr>
<td>BBB</td>
<td>0.07</td>
<td>1.32</td>
<td>19.60</td>
<td>69.49</td>
<td>9.03</td>
<td>0.42</td>
<td>0.07</td>
</tr>
<tr>
<td>BB</td>
<td>0.04</td>
<td>0.19</td>
<td>1.55</td>
<td>19.36</td>
<td>70.88</td>
<td>7.75</td>
<td>0.23</td>
</tr>
<tr>
<td>B</td>
<td>0.00</td>
<td>0.05</td>
<td>0.24</td>
<td>1.43</td>
<td>21.54</td>
<td>74.36</td>
<td>2.38</td>
</tr>
<tr>
<td>CCC</td>
<td>0.00</td>
<td>0.00</td>
<td>0.22</td>
<td>0.44</td>
<td>2.21</td>
<td>13.24</td>
<td>83.89</td>
</tr>
</tbody>
</table>
The probability that the entity reaches the state $R_j$ at time $t$ given that it has reached the state $R_i$ at time $s$ is equal to:

$$p(s, i; t, j) = \Pr \{ R(t) = R_j \mid R(s) = R_i \} = p_{i,j}^{(t-s)}$$

We note $p_{i,j}^{(n)}$ the $n$-step transition probability:

$$p_{i,j}^{(n)} = \Pr \{ R(t + n) = R_j \mid R(t) = R_i \}$$

and the associated $n$-step transition matrix

$P^{(n)} = \begin{pmatrix} p_{i,j}^{(n)} \end{pmatrix}$
For \( n = 2 \), we obtain:

\[
p^{(2)}_{i,j} = \Pr \{ \mathcal{R}(t + 2) = R_j \mid \mathcal{R}(t) = R_i \} \\
= \sum_{k=1}^{K} \Pr \{ \mathcal{R}(t + 2) = R_j, \mathcal{R}(t + 1) = R_k \mid \mathcal{R}(t) = R_i \} \\
= \sum_{k=1}^{K} \Pr \{ \mathcal{R}(t + 2) = R_j \mid \mathcal{R}(t + 1) = R_k \} \cdot \Pr \{ \mathcal{R}(t + 1) = R_k \mid \mathcal{R}(t) = R_i \} \\
= \sum_{k=1}^{K} p_{i,k} \cdot p_{k,j}
\]
The forward Chapman-Kolmogorov equation is:

\[ p_{i,j}^{(n+m)} = \sum_{k=1}^{K} p_{i,k}^{(n)} \cdot p_{k,j}^{(m)} \quad \forall n, m > 0 \]

or \( P^{n+m} = P^n \cdot P^m \) with \( P^0 = I \)

We have:

\[
\begin{align*}
P(n) &= P(n-1) \cdot P(1) \\
&= P(n-2) \cdot P(1) \cdot P(1) \\
&= \prod_{t=1}^{n} P(1) \\
&= P^n
\end{align*}
\]

We deduce that:

\[ p(t, i; t + n, j) = p_{i,j}^{(n)} = e_i^\top P^n e_j \]
Table 17: Two-year transition probability in % (migration matrix #1)

<table>
<thead>
<tr>
<th></th>
<th>AAA</th>
<th>AA</th>
<th>A</th>
<th>BBB</th>
<th>BB</th>
<th>B</th>
<th>CCC</th>
</tr>
</thead>
<tbody>
<tr>
<td>AAA</td>
<td>86.28</td>
<td>10.08</td>
<td>2.25</td>
<td>0.92</td>
<td>0.44</td>
<td>0.02</td>
<td>0.00</td>
</tr>
<tr>
<td>AA</td>
<td>7.30</td>
<td>70.52</td>
<td>18.68</td>
<td>2.67</td>
<td>0.66</td>
<td>0.15</td>
<td>0.00</td>
</tr>
<tr>
<td>A</td>
<td>0.95</td>
<td>24.24</td>
<td>57.16</td>
<td>15.20</td>
<td>2.19</td>
<td>0.25</td>
<td>0.01</td>
</tr>
<tr>
<td>BBB</td>
<td>0.21</td>
<td>5.06</td>
<td>28.22</td>
<td>52.11</td>
<td>12.93</td>
<td>1.33</td>
<td>0.14</td>
</tr>
<tr>
<td>BB</td>
<td>0.09</td>
<td>0.79</td>
<td>6.07</td>
<td>27.45</td>
<td>53.68</td>
<td>11.37</td>
<td>0.55</td>
</tr>
<tr>
<td>B</td>
<td>0.01</td>
<td>0.18</td>
<td>0.98</td>
<td>6.26</td>
<td>31.47</td>
<td>57.28</td>
<td>3.82</td>
</tr>
<tr>
<td>CCC</td>
<td>0.00</td>
<td>0.05</td>
<td>0.50</td>
<td>1.32</td>
<td>6.31</td>
<td>21.13</td>
<td>70.70</td>
</tr>
</tbody>
</table>
We have:

\[ p^{(2)}_{\text{AAA,AAA}} = p_{\text{AAA,AAA}} \times p_{\text{AAA,AAA}} + p_{\text{AAA,AA}} \times p_{\text{AA,AAA}} + p_{\text{AAA,A}} \times p_{\text{A,AAA}} + \\
p_{\text{AAA,BBB}} \times p_{\text{BBB,AAA}} + p_{\text{AAA,BB}} \times p_{\text{BB,AAA}} + \\
p_{\text{AAA,B}} \times p_{\text{B,AAA}} + p_{\text{AAA,CCC}} \times p_{\text{CCC,AAA}} \]

\[ = 0.9276^2 + 0.0566 \times 0.0415 + 0.0090 \times 0.0018 + \\
0.0045 \times 0.0007 + 0.0023 \times 0.0004 \]

\[ = 86.28\% \]
### Table 18: Five-year transition probability in % (migration matrix #1)

<table>
<thead>
<tr>
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<th>AA</th>
<th>A</th>
<th>BBB</th>
<th>BB</th>
<th>B</th>
<th>CCC</th>
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<tr>
<td>AAA</td>
<td>70.45</td>
<td>18.69</td>
<td>6.97</td>
<td>2.61</td>
<td>1.08</td>
<td>0.18</td>
<td>0.01</td>
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<tr>
<td>AA</td>
<td>13.13</td>
<td>50.21</td>
<td>26.03</td>
<td>7.90</td>
<td>2.22</td>
<td>0.48</td>
<td>0.03</td>
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<tr>
<td>A</td>
<td>4.35</td>
<td>33.20</td>
<td>37.78</td>
<td>17.99</td>
<td>5.52</td>
<td>1.08</td>
<td>0.09</td>
</tr>
<tr>
<td>BBB</td>
<td>1.50</td>
<td>16.49</td>
<td>32.49</td>
<td>30.90</td>
<td>14.61</td>
<td>3.63</td>
<td>0.38</td>
</tr>
<tr>
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<td>0.50</td>
<td>5.98</td>
<td>17.83</td>
<td>30.10</td>
<td>31.35</td>
<td>12.85</td>
<td>1.39</td>
</tr>
<tr>
<td>B</td>
<td>0.15</td>
<td>1.90</td>
<td>7.40</td>
<td>18.95</td>
<td>35.11</td>
<td>31.26</td>
<td>5.23</td>
</tr>
<tr>
<td>CCC</td>
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<td>0.64</td>
<td>2.55</td>
<td>6.93</td>
<td>17.96</td>
<td>38.54</td>
<td>43.33</td>
</tr>
</tbody>
</table>
Rating migration matrix
Discrete time modeling

Stationary distribution

- $\pi^{(n)}_k = \Pr \{ R(n) = R_k \}$ is the probability of the state $R_k$ at time $n$:
- $\pi^{(n)} = (\pi^{(n)}_1, \ldots, \pi^{(n)}_K)$ satisfies $\pi^{(n+1)} = P^\top \pi^{(n)}$
- The Markov chain $R$ has a stationary distribution $\pi^*$ if $\pi^* = P^\top \pi^*$
- $T_k = \inf \{ n : R(n) = R_k \ | \ R(0) = R_k \}$ is the return period of state $R_k$
- The average return period is then equal to:

$$\tau_k := \mathbb{E} [T_k] = \frac{1}{\pi^*_k}$$
We obtain:

\[ \pi^* = (17.78\%, 29.59\%, 25.12\%, 15.20\%, 8.35\%, 3.29\%, 0.67\%) \]

The average return periods are then equal to 5.6, 3.4, 4.0, 6.6, 12.0, 30.4 and 149.0 years

⇒ Best-in-class (or winning-) oriented system
Table 19: ESG migration matrix #2 (one-month transition probability in %)

<table>
<thead>
<tr>
<th></th>
<th>AAA</th>
<th>AA</th>
<th>A</th>
<th>BBB</th>
<th>BB</th>
<th>B</th>
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</thead>
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<td>0.50</td>
<td>0.00</td>
<td>0.00</td>
</tr>
<tr>
<td>AA</td>
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<td>93.00</td>
<td>4.00</td>
<td>0.50</td>
<td>0.50</td>
<td>0.00</td>
<td>0.00</td>
</tr>
<tr>
<td>A</td>
<td>0.00</td>
<td>3.00</td>
<td>93.00</td>
<td>3.90</td>
<td>0.10</td>
<td>0.00</td>
<td>0.00</td>
</tr>
<tr>
<td>BBB</td>
<td>0.00</td>
<td>0.10</td>
<td>2.80</td>
<td>94.00</td>
<td>3.00</td>
<td>0.10</td>
<td>0.00</td>
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<tr>
<td>BB</td>
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<td>0.00</td>
<td>0.10</td>
<td>3.50</td>
<td>94.50</td>
<td>1.80</td>
<td>0.10</td>
</tr>
<tr>
<td>B</td>
<td>0.00</td>
<td>0.00</td>
<td>0.00</td>
<td>0.10</td>
<td>3.70</td>
<td>96.00</td>
<td>0.20</td>
</tr>
<tr>
<td>CCC</td>
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<td>0.00</td>
<td>0.00</td>
<td>0.40</td>
<td>0.50</td>
<td>0.60</td>
<td>98.50</td>
</tr>
</tbody>
</table>

⇒ The stationary distribution is
\[ \pi^* = (3.11\%, 10.10\%, 17.46\%, 27.76\%, 25.50\%, 12.68\%, 3.39\%) \] and the average return periods are equal to 32.2, 9.9, 5.7, 3.6, 3.9, 7.9 and 29.5 years
⇒ balanced rating system
### Table 20: One-year probability transition in % (migration matrix #2)

<table>
<thead>
<tr>
<th></th>
<th>AAA</th>
<th>AA</th>
<th>A</th>
<th>BBB</th>
<th>BB</th>
<th>B</th>
<th>CCC</th>
</tr>
</thead>
<tbody>
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<td>AAA</td>
<td>48.06</td>
<td>29.71</td>
<td>10.34</td>
<td>6.42</td>
<td>4.95</td>
<td>0.49</td>
<td>0.03</td>
</tr>
<tr>
<td>AA</td>
<td>11.65</td>
<td>49.25</td>
<td>24.10</td>
<td>9.60</td>
<td>4.87</td>
<td>0.49</td>
<td>0.03</td>
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<td>A</td>
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<td>17.51</td>
<td>49.67</td>
<td>24.72</td>
<td>5.52</td>
<td>0.54</td>
<td>0.03</td>
</tr>
<tr>
<td>BBB</td>
<td>0.27</td>
<td>3.53</td>
<td>17.46</td>
<td>55.50</td>
<td>20.21</td>
<td>2.88</td>
<td>0.16</td>
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<tr>
<td>BB</td>
<td>0.03</td>
<td>0.60</td>
<td>4.21</td>
<td>23.43</td>
<td>57.45</td>
<td>13.27</td>
<td>1.01</td>
</tr>
<tr>
<td>B</td>
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<td>0.08</td>
<td>0.74</td>
<td>5.94</td>
<td>27.10</td>
<td>64.18</td>
<td>1.96</td>
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<td>0.07</td>
<td>0.57</td>
<td>4.22</td>
<td>5.77</td>
<td>5.85</td>
<td>83.51</td>
</tr>
</tbody>
</table>
Rating migration matrix
Discrete time modeling

Table 21: One-month probability transition in % (migration matrix #1)

<table>
<thead>
<tr>
<th></th>
<th>AAA</th>
<th>AA</th>
<th>A</th>
<th>BBB</th>
<th>BB</th>
<th>B</th>
<th>CCC</th>
</tr>
</thead>
<tbody>
<tr>
<td>AAA</td>
<td>99.36</td>
<td>0.53</td>
<td>0.05</td>
<td>0.04</td>
<td>0.02</td>
<td>0.00</td>
<td>0.00</td>
</tr>
<tr>
<td>AA</td>
<td>0.39</td>
<td>98.31</td>
<td>1.26</td>
<td>0.01</td>
<td>0.03</td>
<td>0.01</td>
<td>0.00</td>
</tr>
<tr>
<td>A</td>
<td>-0.02</td>
<td>1.65</td>
<td>97.14</td>
<td>1.21</td>
<td>0.02</td>
<td>0.01</td>
<td>0.00</td>
</tr>
<tr>
<td>BBB</td>
<td>0.01</td>
<td>-0.07</td>
<td>2.28</td>
<td>96.72</td>
<td>1.06</td>
<td>-0.01</td>
<td>0.01</td>
</tr>
<tr>
<td>BB</td>
<td>0.00</td>
<td>0.02</td>
<td>-0.12</td>
<td>2.29</td>
<td>96.92</td>
<td>0.88</td>
<td>0.01</td>
</tr>
<tr>
<td>B</td>
<td>0.00</td>
<td>0.00</td>
<td>0.04</td>
<td>-0.15</td>
<td>2.45</td>
<td>97.42</td>
<td>0.25</td>
</tr>
<tr>
<td>CCC</td>
<td>0.00</td>
<td>0.00</td>
<td>0.02</td>
<td>0.04</td>
<td>0.05</td>
<td>1.37</td>
<td>98.53</td>
</tr>
</tbody>
</table>

⇒ Negative probabilities

The ESG rating system is not Markovian!
Let $A \subset K$ be a given subset. The first hitting time of $A$ is given by:

$$T(A) = \inf \{ n : R(n) \in A \}$$

The mean first hitting time to target $A$ from state $k$ is defined as:

$$\tau_k(A) = \mathbb{E}[T(A) \mid R(0) = R_k]$$

We can show that $\tau_k(A) = 1 + \sum_{j=1}^{K} p_{k,j} \tau_j(A)$

The solution is given by the LP problem:

$$\tau(A) = \arg \min \sum_{k=1}^{K} x_k \quad \text{s.t.} \begin{cases} x_k = 0 & \text{if } k \in A \\ x_k = 1 + \sum_{j=1}^{K} p_{k,j} x_j & \text{if } k \notin A \\ x_k \geq 0 \end{cases}$$
### Rating migration matrix

Discrete time modeling

- $\mathcal{B} = \{\text{AAA, AA, A}\}$
- $\mathcal{W} = \{\text{BB, B, CCC}\}$

<table>
<thead>
<tr>
<th>Rating system</th>
<th>$\mathcal{W}$-target</th>
<th>$\mathcal{B}$-target</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>AAA</td>
<td>AA</td>
</tr>
<tr>
<td>#1</td>
<td>79.21</td>
<td>70.04</td>
</tr>
</tbody>
</table>
Theoretical approach:

- Bayes theorem:

$$p_{i,j} = \frac{\Pr \{ \mathcal{R} (t + 1) = R_j \mid \mathcal{R} (t) = R_i \}}{\Pr \{ \mathcal{R} (t) = R_i \}}$$

- We have seen that:

$$\Pr \{ \mathcal{R} (t) = R_k \} = F (s^*_k) - F (s^*_{k-1}) = p_k$$

- We deduce that:

$$p_{i,j} = \frac{C \left( F (s^*_i), F (s^*_j) \right) - C \left( F (s^*_{i-1}), F (s^*_j) \right) - C \left( F (s^*_i), F (s^*_{j-1}) \right) + C \left( F (s^*_{i-1}), F (s^*_{j-1}) \right)}{F (s^*_i) - F (s^*_{i-1})}$$

where $C$ is the copula function of the random vector $(\mathcal{S} (t), \mathcal{S} (t + 1))$. 
Non-parametric approach:

\[ \hat{p}_{i,j}(t) = \frac{\# \{ R(t+1) = R_j, R(t) = R_i \}}{\# \{ R(t) = R_i \}} = \frac{n_{i,j}(t)}{n_{i,.}(t)} \]

⇒ cohort method vs. pooling method
### Table 22: Number of observations $n_{i,j}$ (migration matrix #1)

<table>
<thead>
<tr>
<th>$n_{i,j}$</th>
<th>AAA</th>
<th>AA</th>
<th>A</th>
<th>BBB</th>
<th>BB</th>
<th>B</th>
<th>CCC</th>
<th>$n_{i,\cdot} (t)$</th>
<th>$\hat{p}_{i,\cdot} (t)$</th>
</tr>
</thead>
<tbody>
<tr>
<td>AAA</td>
<td>2050</td>
<td>125</td>
<td>20</td>
<td>10</td>
<td>5</td>
<td>0</td>
<td>0</td>
<td>2210</td>
<td>3.683%</td>
</tr>
<tr>
<td>AA</td>
<td>280</td>
<td>5580</td>
<td>800</td>
<td>60</td>
<td>20</td>
<td>5</td>
<td>0</td>
<td>6745</td>
<td>11.242%</td>
</tr>
<tr>
<td>A</td>
<td>20</td>
<td>1700</td>
<td>8020</td>
<td>1150</td>
<td>90</td>
<td>10</td>
<td>0</td>
<td>10990</td>
<td>18.317%</td>
</tr>
<tr>
<td>BBB</td>
<td>10</td>
<td>190</td>
<td>2820</td>
<td>10000</td>
<td>1300</td>
<td>60</td>
<td>10</td>
<td>14390</td>
<td>23.983%</td>
</tr>
<tr>
<td>BB</td>
<td>5</td>
<td>25</td>
<td>200</td>
<td>2500</td>
<td>9150</td>
<td>1000</td>
<td>30</td>
<td>12910</td>
<td>21.517%</td>
</tr>
<tr>
<td>B</td>
<td>0</td>
<td>5</td>
<td>25</td>
<td>150</td>
<td>2260</td>
<td>7800</td>
<td>250</td>
<td>10490</td>
<td>17.483%</td>
</tr>
<tr>
<td>CCC</td>
<td>0</td>
<td>0</td>
<td>5</td>
<td>10</td>
<td>50</td>
<td>300</td>
<td>1900</td>
<td>2265</td>
<td>3.775%</td>
</tr>
<tr>
<td>$n_{\cdot, j} (t)$</td>
<td>2365</td>
<td>7625</td>
<td>11890</td>
<td>13850</td>
<td>12875</td>
<td>9175</td>
<td>2190</td>
<td>60000</td>
<td>100.00%</td>
</tr>
</tbody>
</table>

| $\hat{p}_{\cdot, j} (t)$ | 3.942% | 12.708% | 19.817% | 23.133% | 21.458% | 15.292% | 3.650% |

Rating migration matrix
Estimation of the transition matrix
Rating migration matrix
Estimation of the transition matrix

For the migration matrix #1, we have:

\[ \pi^* = (17.78\%, 29.59\%, 25.12\%, 15.20\%, 8.35\%, 3.29\%, 0.67\%) \]

The initial empirical distribution of ratings is:

\[ \hat{\pi}^{(0)} = (3.683\%, 11.242\%, 18.317\%, 23.983\%, 21.517\%, 17.483\%, 3.775\%) \]

We have:

\[ \hat{\pi}^{(1)} = \hat{P}^T \hat{\pi}^{(0)} \]
\[ = (3.942\%, 12.708\%, 19.817\%, 23.133\%, 21.458\%, 15.290\%, 3.650\%) \]
Figure 21: Dynamics of the probability distribution $\pi^{(n)}$ (migration matrix #1)
The transition matrix is defined as follows:

\[ P_{i,j} (s; t) = p(s, i; t, j) = \Pr \{ R(t) = R_j | R(s) = R_i \} \]

If \( R \) is a time-homogenous Markov, we have:

\[ P(t) = P(0; t) = \exp(t\Lambda) \]

\( \Lambda = (\lambda_{i,j}) \) is the Markov generator matrix \( \Lambda = (\lambda_{i,j}) \) where \( \lambda_{i,j} \geq 0 \) for all \( i \neq j \) and \( \lambda_{i,i} = -\sum_{j \neq i}^{K} \lambda_{i,j} \)
Rating migration matrix
Continuous-time modeling

An example

- Rating system with three states: A (good rating), B (average rating) and C (bad rating)
- The Markov generator is equal to:

\[ \Lambda = \begin{pmatrix} 
-0.30 & 0.20 & 0.10 \\
0.15 & -0.40 & 0.25 \\
0.10 & 0.15 & -0.25 
\end{pmatrix} \]
The one-year transition probability matrix is equal to:

\[ P(1) = e^\Lambda = \begin{pmatrix} 75.63\% & 14.84\% & 9.53\% \\ 11.63\% & 69.50\% & 18.87\% \\ 8.52\% & 11.73\% & 79.75\% \end{pmatrix} \]

For the two-year maturity, we get:

\[ P(2) = e^{2\Lambda} = \begin{pmatrix} 59.74\% & 22.65\% & 17.61\% \\ 18.49\% & 52.24\% & 29.27\% \\ 14.60\% & 18.76\% & 66.63\% \end{pmatrix} \]

We verify that \( P(2) = P(1) \cdot P(1) \) because:

\[ P(t) = e^{t\Lambda} = (e^\Lambda)^t = P(1)^t \]

We have:

\[ P\left(\frac{1}{12}\right) = e^{\frac{1}{12}\Lambda} = \begin{pmatrix} 97.54\% & 1.62\% & 0.83 \\ 1.22\% & 96.74\% & 2.03 \\ 0.82\% & 1.22\% & 97.95 \end{pmatrix} \]
Matrix function

We consider the matrix function in the space $\mathbb{M}$ of square matrices:

$$f : \mathbb{M} \rightarrow \mathbb{M}$$

$$A \mapsto B = f(A)$$

For instance, if $f(x) = \sqrt{x}$ and $A$ is positive, we can define the matrix $B$ such that:

$$BB^* = B^*B = A$$

$B$ is called the square root of $A$ and we note $B = A^{1/2}$.
We consider the following Taylor expansion:

\[ f(x) = f(x_0) + (x - x_0) f'(x_0) + \frac{(x - x_0)^2}{2!} f''(x_0) + \ldots \]

We can show that if the series converge for \(|x - x_0| < \alpha\), then the matrix \( f(A) \) defined by the following expression:

\[ f(A) = f(x_0) + (A - x_0I) f'(x_0) + \frac{(A - x_0I)^2}{2!} f''(x_0) + \ldots \]

converges to the matrix \( B \) if \(|A - x_0I| < \alpha\) and we note \( B = f(A) \).
In the case of the exponential function, we have:

\[ f(x) = e^x = \sum_{k=0}^{\infty} \frac{x^k}{k!} \]

We deduce that the exponential of the matrix \( A \) is equal to:

\[ B = e^A = \sum_{k=0}^{\infty} \frac{A^k}{k''!} \]

The logarithm of \( A \) is the matrix \( B \) such that \( e^B = A \) and we note \( B = \ln A \)
Let $A$ and $B$ be two $n \times n$ square matrices. We have the properties:

\[
\begin{align*}
  f(A^\top) &= f(A)^\top \\
  Af(A) &= f(A)A \\
  f(B^{-1}AB) &= B^{-1}f(A)B
\end{align*}
\]

It follows that:

\[
\begin{align*}
  e^{A^\top} &= (e^A)^\top \\
  e^{B^{-1}AB} &= B^{-1}e^A B \\
  Ae^B &= e^B A & \text{if } AB = BA \\
  e^{A+B} &= e^A e^B = e^B e^A & \text{if } AB = BA
\end{align*}
\]
Definition

The Schur decomposition of the $n \times n$ matrix $A$ is equal to:

$$A = QTQ^*$$

where $Q$ is a unitary matrix and $T$ is an upper triangular matrix

For transcendental functions, we have:

$$f(A) = Qf(T)Q^*$$

where $A = QTQ^*$ is the Schur decomposition of $A$
We have:

\[ \hat{\Lambda} = \frac{1}{t} \ln \left( \hat{P}(t) \right) \]

\[
\Rightarrow \hat{\Lambda} \text{ may not verify the Markov conditions: } \hat{\lambda}_{i,j} \geq 0 \text{ for all } i \neq j \text{ and } \\
\sum_{j=1}^{K} \lambda_{i,j} = 0
\]
Table 23: Non-Markov generator $\Lambda' = \ln(P)$ of the migration matrix #1 (in %)

<table>
<thead>
<tr>
<th></th>
<th>AAA</th>
<th>AA</th>
<th>A</th>
<th>BBB</th>
<th>BB</th>
<th>B</th>
<th>CCC</th>
</tr>
</thead>
<tbody>
<tr>
<td>AAA</td>
<td>-7.663</td>
<td>6.427</td>
<td>0.542</td>
<td>0.466</td>
<td>0.245</td>
<td>-0.016</td>
<td>-0.000</td>
</tr>
<tr>
<td>AA</td>
<td>4.770</td>
<td>-20.604</td>
<td>15.451</td>
<td>-0.001</td>
<td>0.318</td>
<td>0.066</td>
<td>-0.001</td>
</tr>
<tr>
<td>A</td>
<td>-0.267</td>
<td>20.259</td>
<td>-35.172</td>
<td>14.953</td>
<td>0.152</td>
<td>0.083</td>
<td>-0.008</td>
</tr>
<tr>
<td>BBB</td>
<td>0.102</td>
<td>-1.051</td>
<td>28.263</td>
<td>-40.366</td>
<td>13.100</td>
<td>-0.128</td>
<td>0.080</td>
</tr>
<tr>
<td>BB</td>
<td>0.032</td>
<td>0.307</td>
<td>-1.762</td>
<td>28.351</td>
<td>-37.889</td>
<td>10.832</td>
<td>0.129</td>
</tr>
<tr>
<td>B</td>
<td>-0.005</td>
<td>-0.008</td>
<td>0.503</td>
<td>-2.240</td>
<td>30.227</td>
<td>-31.482</td>
<td>3.006</td>
</tr>
<tr>
<td>CCC</td>
<td>0.000</td>
<td>-0.024</td>
<td>0.194</td>
<td>0.469</td>
<td>0.365</td>
<td>16.806</td>
<td>-17.810</td>
</tr>
</tbody>
</table>
The first approach consists in adding the negative values back into the diagonal values:

\[
\begin{align*}
\bar{\lambda}_{i,j} &= \max(\hat{\lambda}_{i,j}, 0) \quad i \neq j \\
\bar{\lambda}_{i,i} &= \hat{\lambda}_{i,i} + \sum_{j \neq i} \min(\hat{\lambda}_{i,j}, 0)
\end{align*}
\]

The second estimator carries forward the negative values on the matrix entries which have the correct sign:

\[
\begin{align*}
G_i &= \left|\hat{\lambda}_{i,i}\right| + \sum_{j \neq i} \max(\hat{\lambda}_{i,j}, 0), \\
B_i &= \sum_{j \neq i} \max(-\hat{\lambda}_{i,j}, 0) \\
\tilde{\lambda}_{i,j} &= \begin{cases} 
0 & \text{if } i \neq j \text{ and } \hat{\lambda}_{i,j} < 0 \\
\hat{\lambda}_{i,j} - B_i & \text{ if } G_i > 0 \\
\hat{\lambda}_{i,j} / G_i & \text{ if } G_i = 0
\end{cases}
\end{align*}
\]
Table 24: Markov generator of the migration matrix #1 (in %)

<table>
<thead>
<tr>
<th></th>
<th>AAA</th>
<th>AA</th>
<th>A</th>
<th>BBB</th>
<th>BB</th>
<th>B</th>
<th>CCC</th>
</tr>
</thead>
<tbody>
<tr>
<td>AAA</td>
<td>−7.679</td>
<td>6.427</td>
<td>0.542</td>
<td>0.466</td>
<td>0.245</td>
<td>0.000</td>
<td>0.000</td>
</tr>
<tr>
<td>AA</td>
<td>4.770</td>
<td>−20.606</td>
<td>15.451</td>
<td>0.000</td>
<td>0.318</td>
<td>0.066</td>
<td>0.000</td>
</tr>
<tr>
<td>A</td>
<td>0.000</td>
<td>20.259</td>
<td>−35.447</td>
<td>14.953</td>
<td>0.152</td>
<td>0.083</td>
<td>0.000</td>
</tr>
<tr>
<td>BBB</td>
<td>0.102</td>
<td>0.000</td>
<td>28.263</td>
<td>−41.545</td>
<td>13.100</td>
<td>0.000</td>
<td>0.080</td>
</tr>
<tr>
<td>BB</td>
<td>0.032</td>
<td>0.307</td>
<td>0.000</td>
<td>38.351</td>
<td>−39.651</td>
<td>10.832</td>
<td>0.129</td>
</tr>
<tr>
<td>B</td>
<td>0.000</td>
<td>0.000</td>
<td>0.503</td>
<td>0.000</td>
<td>30.227</td>
<td>−33.735</td>
<td>3.006</td>
</tr>
<tr>
<td>CCC</td>
<td>0.000</td>
<td>0.000</td>
<td>0.194</td>
<td>0.469</td>
<td>0.365</td>
<td>16.806</td>
<td>−17.834</td>
</tr>
</tbody>
</table>
### Table 25: ESG migration Markov matrix #1 (one-year transition probability in %)

<table>
<thead>
<tr>
<th></th>
<th>AAA</th>
<th>AA</th>
<th>A</th>
<th>BBB</th>
<th>BB</th>
<th>B</th>
<th>CCC</th>
</tr>
</thead>
<tbody>
<tr>
<td>AAA</td>
<td>92.75</td>
<td>5.66</td>
<td>0.90</td>
<td>0.45</td>
<td>0.23</td>
<td>0.01</td>
<td>0.00</td>
</tr>
<tr>
<td>AA</td>
<td>4.17</td>
<td>82.73</td>
<td>11.85</td>
<td>0.89</td>
<td>0.30</td>
<td>0.07</td>
<td>0.00</td>
</tr>
<tr>
<td>A</td>
<td>0.40</td>
<td>15.51</td>
<td>72.79</td>
<td>10.39</td>
<td>0.81</td>
<td>0.10</td>
<td>0.01</td>
</tr>
<tr>
<td>BBB</td>
<td>0.12</td>
<td>2.11</td>
<td>19.60</td>
<td>68.69</td>
<td>8.91</td>
<td>0.50</td>
<td>0.07</td>
</tr>
<tr>
<td>BB</td>
<td>0.04</td>
<td>0.43</td>
<td>2.79</td>
<td>19.25</td>
<td>69.65</td>
<td>7.61</td>
<td>0.23</td>
</tr>
<tr>
<td>B</td>
<td>0.01</td>
<td>0.09</td>
<td>0.65</td>
<td>2.98</td>
<td>21.21</td>
<td>72.71</td>
<td>2.35</td>
</tr>
<tr>
<td>CCC</td>
<td>0.00</td>
<td>0.02</td>
<td>0.25</td>
<td>0.58</td>
<td>2.19</td>
<td>13.09</td>
<td>83.87</td>
</tr>
</tbody>
</table>
### Table 26: Original migration matrix

<table>
<thead>
<tr>
<th></th>
<th>AAA</th>
<th>AA</th>
<th>A</th>
<th>BBB</th>
<th>BB</th>
<th>B</th>
<th>CCC</th>
</tr>
</thead>
<tbody>
<tr>
<td>AAA</td>
<td>92.76</td>
<td>5.66</td>
<td>0.90</td>
<td>0.45</td>
<td>0.23</td>
<td>0.00</td>
<td>0.00</td>
</tr>
<tr>
<td>AA</td>
<td>4.15</td>
<td>82.73</td>
<td>11.86</td>
<td>0.89</td>
<td>0.30</td>
<td>0.07</td>
<td>0.00</td>
</tr>
<tr>
<td>A</td>
<td>0.18</td>
<td>15.47</td>
<td>72.98</td>
<td>10.46</td>
<td>0.82</td>
<td>0.09</td>
<td>0.00</td>
</tr>
<tr>
<td>BBB</td>
<td>0.07</td>
<td>1.32</td>
<td>19.60</td>
<td>69.49</td>
<td>9.03</td>
<td>0.42</td>
<td>0.07</td>
</tr>
<tr>
<td>BB</td>
<td>0.04</td>
<td>0.19</td>
<td>1.55</td>
<td>19.36</td>
<td>70.88</td>
<td>7.75</td>
<td>0.23</td>
</tr>
<tr>
<td>B</td>
<td>0.00</td>
<td>0.05</td>
<td>0.24</td>
<td>1.43</td>
<td>21.54</td>
<td>74.36</td>
<td>2.38</td>
</tr>
<tr>
<td>CCC</td>
<td>0.00</td>
<td>0.00</td>
<td>0.22</td>
<td>0.44</td>
<td>2.21</td>
<td>13.24</td>
<td>83.89</td>
</tr>
</tbody>
</table>

### Table 27: New migration matrix

<table>
<thead>
<tr>
<th></th>
<th>AAA</th>
<th>AA</th>
<th>A</th>
<th>BBB</th>
<th>BB</th>
<th>B</th>
<th>CCC</th>
</tr>
</thead>
<tbody>
<tr>
<td>AAA</td>
<td>92.75</td>
<td>5.66</td>
<td>0.90</td>
<td>0.45</td>
<td>0.23</td>
<td>0.01</td>
<td>0.00</td>
</tr>
<tr>
<td>AA</td>
<td>4.17</td>
<td>82.73</td>
<td>11.85</td>
<td>0.89</td>
<td>0.30</td>
<td>0.07</td>
<td>0.00</td>
</tr>
<tr>
<td>A</td>
<td>0.40</td>
<td>15.51</td>
<td>72.79</td>
<td>10.39</td>
<td>0.81</td>
<td>0.10</td>
<td>0.01</td>
</tr>
<tr>
<td>BBB</td>
<td>0.12</td>
<td>2.11</td>
<td>19.60</td>
<td>68.69</td>
<td>8.91</td>
<td>0.50</td>
<td>0.07</td>
</tr>
<tr>
<td>BB</td>
<td>0.04</td>
<td>0.43</td>
<td>2.79</td>
<td>19.25</td>
<td>69.65</td>
<td>7.61</td>
<td>0.23</td>
</tr>
<tr>
<td>B</td>
<td>0.01</td>
<td>0.09</td>
<td>0.65</td>
<td>2.98</td>
<td>21.21</td>
<td>72.71</td>
<td>2.35</td>
</tr>
<tr>
<td>CCC</td>
<td>0.00</td>
<td>0.02</td>
<td>0.25</td>
<td>0.58</td>
<td>2.19</td>
<td>13.09</td>
<td>83.87</td>
</tr>
</tbody>
</table>
Why it is important that ESG ratings satisfy the Markov property

- Lack of memory:

<table>
<thead>
<tr>
<th></th>
<th>t - 2</th>
<th>t - 1</th>
<th>t</th>
<th>t + 1</th>
</tr>
</thead>
<tbody>
<tr>
<td>AAA</td>
<td>BBB</td>
<td>BBB</td>
<td>BBB</td>
<td>?</td>
</tr>
<tr>
<td>BBB</td>
<td>BBB</td>
<td>BBB</td>
<td>BBB</td>
<td>?</td>
</tr>
<tr>
<td>BB</td>
<td>BB</td>
<td>BB</td>
<td>BBB</td>
<td>?</td>
</tr>
</tbody>
</table>

- Non-Markov property:

\[
\Pr \{ \mathcal{R}_{c_1} (t + 1) = R_j \mid \mathcal{R}_{c_1} (t) = R_i \} \neq \Pr \{ \mathcal{R}_{c_2} (t + 1) = R_j \mid \mathcal{R}_{c_2} (t) = R_i \}
\]

for two different companies \( c_1 \) and \( c_2 \)
How to perform a dynamic analysis?

- We deduce that:

\[
\pi_k (t, A) = \Pr \{ R(t) \in A \mid R(0) = k \} = \sum_{j \in A} e_k^T e^t \Lambda^m e_j
\]

- Some properties
  - \( \partial_t \exp (\Lambda t) = \Lambda \exp (\Lambda t) \)
  - \( \partial_t^m \exp (\Lambda t) = \Lambda^m \exp (\Lambda t) \)
  - \( \int_0^t e^{\Lambda s} ds = (e^{\Lambda t} - I_K) \Lambda^{-1} \)

- For example, the "time density function" is given by:

\[
\pi_k^{(m)} (t, A) := \frac{\partial \pi_k (t, A)}{\partial t^m} = \sum_{j \in A} e_k^T \Lambda^m e^t \Lambda^m e_j
\]
Figure 22: Probability $\pi_k(t, A)$ to reach $A$ at time $t$ (migration matrix #1)
Figure 23: Dynamic analysis (migration matrix #1)

\[ \pi_k(t, \text{AAA}) \text{ in } \% \]

\[ \pi_k(t, \text{CCC}) \text{ in } \% \]

\[ \partial_t \pi_k(t, \text{AAA}) \text{ in bps} \]

\[ \partial_t \pi_k(t, \text{CCC}) \text{ in bps} \]
Table 28: Example of credit migration matrix (one-year probability transition in %)

<table>
<thead>
<tr>
<th></th>
<th>AAA</th>
<th>AA</th>
<th>A</th>
<th>BBB</th>
<th>BB</th>
<th>B</th>
<th>CCC</th>
<th>D</th>
</tr>
</thead>
<tbody>
<tr>
<td>AAA</td>
<td>92.82</td>
<td>6.50</td>
<td>0.56</td>
<td>0.06</td>
<td>0.06</td>
<td>0.00</td>
<td>0.00</td>
<td>0.00</td>
</tr>
<tr>
<td>AA</td>
<td>0.63</td>
<td>91.87</td>
<td>6.64</td>
<td>0.65</td>
<td>0.06</td>
<td>0.11</td>
<td>0.04</td>
<td>0.00</td>
</tr>
<tr>
<td>A</td>
<td>0.08</td>
<td>2.26</td>
<td>91.66</td>
<td>5.11</td>
<td>0.61</td>
<td>0.23</td>
<td>0.01</td>
<td>0.04</td>
</tr>
<tr>
<td>BBB</td>
<td>0.05</td>
<td>0.27</td>
<td>5.84</td>
<td>87.74</td>
<td>4.74</td>
<td>0.98</td>
<td>0.16</td>
<td>0.22</td>
</tr>
<tr>
<td>BB</td>
<td>0.04</td>
<td>0.11</td>
<td>0.64</td>
<td>7.85</td>
<td>81.14</td>
<td>8.27</td>
<td>0.89</td>
<td>1.06</td>
</tr>
<tr>
<td>B</td>
<td>0.00</td>
<td>0.11</td>
<td>0.30</td>
<td>0.42</td>
<td>6.75</td>
<td>83.07</td>
<td>3.86</td>
<td>5.49</td>
</tr>
<tr>
<td>CCC</td>
<td>0.19</td>
<td>0.00</td>
<td>0.38</td>
<td>0.75</td>
<td>2.44</td>
<td>12.03</td>
<td>60.71</td>
<td>23.50</td>
</tr>
<tr>
<td>D</td>
<td>0.00</td>
<td>0.00</td>
<td>0.00</td>
<td>0.00</td>
<td>0.00</td>
<td>0.00</td>
<td>0.00</td>
<td>100.00</td>
</tr>
</tbody>
</table>

The trace statistics is equal to:

$$\lambda(t) = \frac{\text{trace} \left( e^{t\Lambda} \right)}{K}$$
Figure 24: Trace statistics of credit and ESG migration matrices