

Methodology Clarification: Special Purpose Vehicles

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Introduction

This document presents Morningstar Sustainalytics' guiding principles and approach to providing ESG assessments for special purpose vehicles (SPVs). We first define and describe the characteristics of SPVs. Then we explain how we determine whether an SPV is eligible for an ESG assessment, if any, and how the assessment is made. This clarification is applicable for all Morningstar Sustainalytics ESG products addressed to investor clients, including the ESG Risk Ratings. It is not applicable to Second Party Opinions, Engagement Services, Fund-level ratings and (Sub-)Sovereign Ratings.

Special Purpose Vehicles (SPVs): Definition and Characteristics

An SPV, also known as a Special Purpose Entity (SPE) or Financial Vehicle (FV), denotes a legally established entity formed by a sponsoring entity for a particular and restricted objective, such as ownership, management, or funding. It stands as a separate corporate entity with its own set of assets, liabilities, and legal standing. Although frequently a subsidiary of the sponsoring entity, an SPV may not always be structured as such.

SPVs typically exhibit one or more of the following characteristics, which serve as further guidance in the identification process:

1. They are created for a specific limited purpose, for example:
 - » Bond issuance to finance group activities or to hold assets or interests to securitize debt issuance;
 - » Structuring a joint venture;
 - » Isolating financial risk and minimizing bankruptcy risk;
 - » Sharing or distributing legal risk;
 - » Financing of public-private projects like infrastructure construction; or
 - » Offshoring for tax or privacy reasons;
2. They are created as separate entities with their own balance sheets;
3. They usually have no operations (or employees) of their own; or

4. They are linked to a sponsoring entity, either through ownership, debt guarantee, or other form of control. The relationship between the sponsoring entity and the business activities facilitated by the SPV can take many forms, e.g., full control, partial interests in cash flows, or simply facilitating bond syndication.

SPV Eligibility for ESG Assessments

The Morningstar Sustainalytics' coverage universe seeks to reflect the investible universe of institutional investors and funds, beginning with the composition of major indices and stock exchanges. This universe may also include those SPVs eligible for an ESG assessment. In determining whether an SPV is eligible for an ESG assessment, we distinguish three possibilities:

- The SPV is eligible for a flow-through ESG assessment;
- The SPV is eligible for a direct ESG assessment; or
- The SPV is ineligible for an ESG assessment.

Morningstar Sustainalytics identifies SPVs by gathering essential data from third-party data providers and company-specific sources (such as the company's website, reports, regulatory filings or other disclosures) through a process called Entity Type Assignment. Following SPV identification, we then determine whether it is eligible for an ESG assessment (either flow-through or direct). The nine Entity Types that could potentially serve as SPVs, each possessing distinct eligibility criteria for ESG assessment. The specific Entity Type determines the type of ESG assessment they are entitled to undergo.

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Entity Type	ESG Assessment Type
Joint Venture	Direct ESG assessment
Operating Subsidiary	Direct ESG assessment
Holding Company	Direct ESG assessment
Financing Subsidiary	Direct ESG assessment OR flow-through ESG assessment
Public company	Direct ESG assessment OR flow-through ESG assessment
Private company	Direct ESG assessment OR flow-through ESG assessment
Asset-Backed Securities	Ineligible for ESG assessment
Trust/Trustee	Ineligible for ESG assessment

For subsidiaries and financing subsidiaries, additional desk research on the corporate structure is performed to determine whether the link between the sponsoring entity and related entity meets the criteria for a flow-through ESG assessment, a direct ESG assessment, or, if neither, is ineligible to receive an ESG assessment altogether. The rules for determining the appropriate ESG Assessment Type in these cases are detailed in the sections below.

Flow-through ESG assessments

In a flow-through ESG assessment, we connect the assessment of a researched entity to securities issued by a related entity. The underlying principle behind a flow-through ESG assessment is that an investment in one entity, such as an SPV, bears the same ESG exposures and risks as an investment in the related researched entity.

Morningstar Sustainalytics publishes ESG assessments for issuers, typically companies or governments. In most cases, individual issuers have issued multiple financial securities, including equity, debt securities, loans, preferred stock and hybrid securities. A mapping process is utilized to ensure that the same ESG assessment outcome flows through all securities mapped to the same entity. In practice, this means that ratings for a company's equity will have an identical score as the rating for its debt issuances.

Flow-through ESG assessments are applicable when the following conditions are met:

- The securities are issued by a related entity (company, subsidiary or holding company, etc.) that is or is controlled by the researched entity; and
- The issuing related entity either:
 - Does not conduct any of its own operations; or
 - Conducts its own operations but said operations are fully guaranteed by the sponsoring entity, and, in the event of a default, the debt will be assumed by the sponsoring entity.
- If the Company Type is Public Company, a flow-through ESG assessment is only applicable for dual-listed companies.

The most straightforward example of an entity eligible for a flow-through ESG assessment is where the SPV operates as a subsidiary within a group structure, specifically focusing on group financing. In these cases, the SPV's primary function is to issue debt that supports the group entity financially and the relevant research entity would be the group's parent or, occasionally, an intermediate operational entity financed by the issuer's securities.

Direct ESG Assessments

Direct ESG assessments are those where the SPV receives the ESG assessment rather than receiving a flow-through assessment from a related entity eligible for an ESG assessment. In principle, direct ESG assessments are required to address the unique character, risks and impacts of the researched entities.

A direct ESG assessment is required when the issuing related-entity either:

- Conducts its own operations that are separate from the operations of its sponsoring entity; or
- Does not conduct its own operations and the SPV's debt is not fully guaranteed by the sponsoring entity.

SPVs Ineligible for ESG Assessments

There are cases where an SPV is neither eligible for a flow-through assessment nor a direct ESG assessment. Ineligibility is determined where:

- The entity has characteristics that make it unsuitable for research under Morningstar Sustainalytics ESG assessment frameworks. For example, some entities do not fit well into any corporate subindustry classification, while subindustry is a key input into some assessment frameworks; or
- Morningstar Sustainalytics does not have sufficient information to determine whether an ESG assessment is appropriate. There are three likely reasons why this may be the case:

- We cannot assess the SPV directly because it has no operations itself or we cannot tell whether it has operations itself;
- We cannot use a flow-through ESG assessment from another eligible entity because the SPV entity is structured in a way that obscures how ESG accountability, exposure, or risk flows between the two entities; or
- We cannot use a flow-through ESG assessment from another eligible entity because we are unable to identify an appropriate related eligible entity to use for the assessment.

ESG Methodology Team