Assessing ESG as a component of bank credit risk

Part 1: Environmental factors

Environmental, social and governance factors are emerging as key elements of bank credit risk. Assessing banks' performance in these areas brings with it challenges, however, including a lack of standardised data and uneven disclosure. This research report, the first of a three-part series, looks at the environmental factors Scope will start to consider in its bank credit assessments.

Scope has streamlined its approach to rate banks to make a combined ESG and Digital factor more explicit, complementing the baseline credit risk factors with the view that successfully managing this factor is a source of credit enhancement.

The foundation of Scope's research into banks' creditworthiness remains the operating environment, banks' business models as well as the risk of regulatory intervention. But ESG and particularly digital factors are having a clear bearing on business models and long-term viability. Key emerging questions include: are digital capabilities being sufficiently invested in to meet changing customer demands? Is sustainable finance expertise being developed to support the funding profile and revenues?

Bank management teams and supervisory boards are facing increasing pressure to explain how they are maximising value for long-term investors, including their social value. As such, the shift towards ESG goals is debtholder friendly because it pushes back on the narrower and often shortsighted goal of shareholder-value maximisation. Therefore, Scope expresses its ESG factor as a potential rating uplift relative to peers rather than a malus.

A well-executed ESG strategy should therefore ultimately improve the credit risk profile of a bank. ESG analysis is in its infancy insofar as bank credit-risk is concerned, so our approach considers an issuer's determination as well as the level of sophistication relative to the market or markets the bank operates in.

ESG factors are having an increasingly visible influence on public and investor confidence in banks. The questions being asked include:

- What sort of relationships do banks have with their various stakeholders? Which processes are in place to ensure effective goal setting and stewardship regarding long-term value maximisation for all stakeholders, including bond investors?
- How are banks managing physical and transition risks related to climate change?
- What about their own impact on the environment, in terms of lending policies or operational setting?
- How are they dealing with employee welfare, skill development, and diversity?
- Are banks investing enough in technology?

The long-term sustainability of a bank will suffer if it is not considered a responsible corporate citizen. It risks losing its social licence to operate from stakeholders well before breaching formal regulatory buffers. The banks most advanced on this front have not just identified the issues but have developed strategic responses and set KPIs that are explicitly linked to top-management compensation.

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Related Research

Scope updates its bank rating methodology
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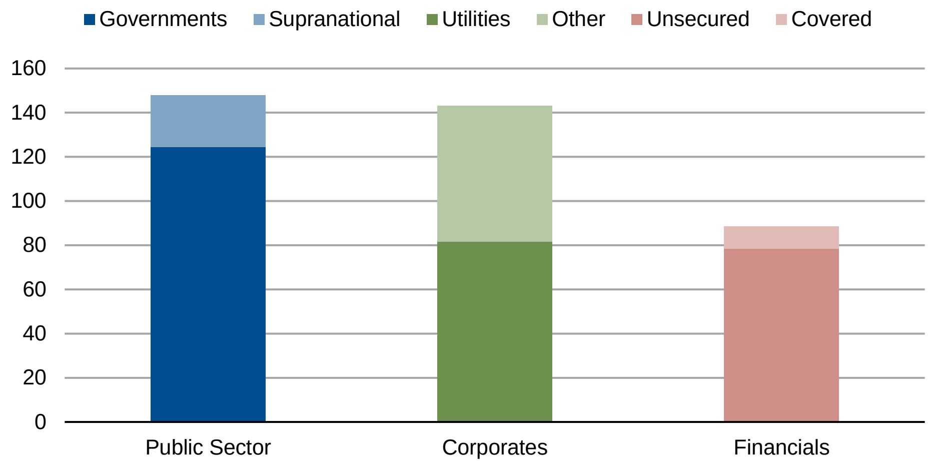
In contrast, banks suffering a poor reputation around ESG, from misconduct to high exposure to potentially mispriced carbon-intensive lending, may find it increasingly difficult to develop their businesses. Reputation issues present a risk of market-share loss.

Reduced investor demand and more difficult access to central banks or public development funds could then negatively affect liquidity and lead to higher funding costs for banks. The opposite may apply to banks that successfully expand their franchises, for example by financing or arranging assets such as green bonds, which still represent a small portion of euro area capital markets (see Figure 1).

Figure 1: EUR denominated green bond issuance



Source: Bloomberg, February 2021, Scope calculations

The notion of ESG factors as potential financial stability risks is growing among bank regulators. Banks will need to demonstrate to their regulators and supervisors that ESG is firmly on their agendas, in particular their management of climate risks. The challenge is that supervisory expectations and eventual requirements are still being determined.

The European Banking Authority has consulted on the risks to which banks are exposed from the impact of ESG factors on their counterparties, while the European Commission has engaged external capital markets advisors to study how ESG factors can be integrated into the EU banking prudential framework. Other regulators, including the Bank of England and Switzerland's FINMA, have taken similar steps. Against the evolving regulatory backdrop, we look for management teams that are seeking to anticipate the potential risks and challenges in this area.

Areas of focus in Scope's ESG research

Environmental risk factors

Environmental risk factors, especially climate risk, tend to dominate ESG analysis, not least due to investor preferences towards green assets and the energy transition policies of governments.

Physical climate risks should be managed through underwriting

We expect banks to adequately manage any direct physical climate risks through underwriting criteria, for example via exclusion criteria or by requiring adequate insurance cover where necessary. As such, these risks are not a novelty because poor underwriting standards have long been recognised as material drivers of bank credit quality.

We expect banks to reflect any rise in the frequency and correlation of climate-related credit losses in their risk capital models.

Climate transition risks more difficult to assess

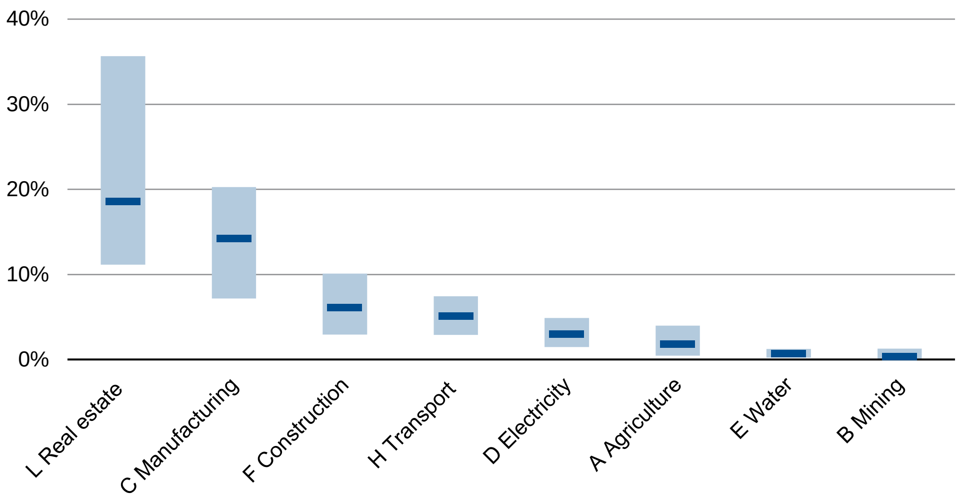
Climate transition risks, by contrast, are less well understood both at the single borrower level and within aggregated portfolios of banking systems. In the face of stakeholder pressure, banks are keen to present themselves as part of the solution for energy transition. Therefore, global efforts such as the UNEP's Principles for Responsible Banking and the Taskforce on Climate-related Financial Disclosures (TCFD) have emerged as key planks for banks' policies regarding net-zero emissions and other ESG targets. These policies apply not only to banks' own operations but more importantly their loan and investment portfolios.

Where is the starting point?

These policies will lead to a shift in bank asset portfolios and revenue streams over time. However, without knowing the starting point, it is difficult to assess the relevance of a bank's long-term carbon-reduction goals (e.g. by 2050) and the subsequent impact of physical and climate transition risk on asset quality and capitalisation within our much shorter rating horizon. Even when considering a much longer time horizon, there are other risks to consider for bank investors, such as technology, demographics, very low interest rates, and geopolitics.

Investors often struggle to determine and benchmark banks' starting points due to the lack of consistent reporting of existing exposures by sector and country or region. For example, in the EU, top-level NACE classifications for corporate exposures (as currently published by the EBA, see Figure 2) are only available in a standardised manner for larger banks. More detailed breakdowns are mostly at the discretion of the reporting banks. We understand this reporting is self-declaratory (not audited), bearing an element of judgment.

Figure 2: Corporate sector exposure of EU Banks by top-level NACE (% of total)



Median and interquartile range

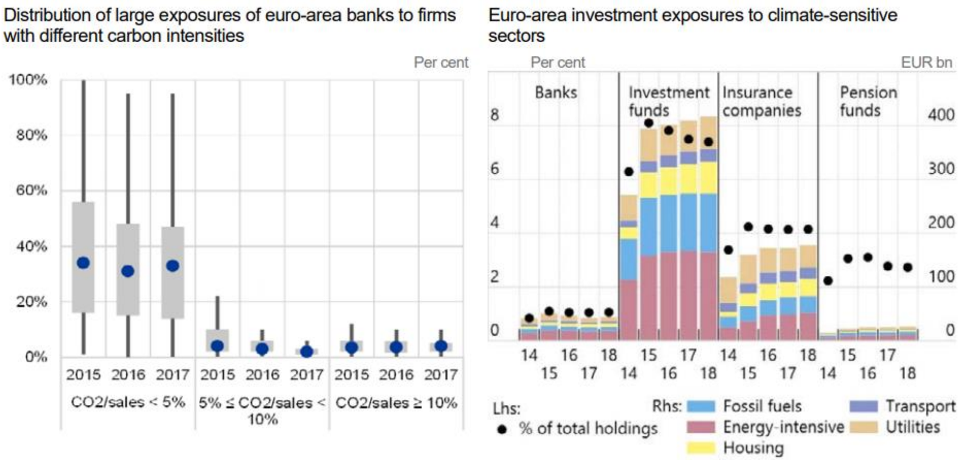
Source: Scope calculations based on EBA transparency data as of June 2020.

Poor disclosure on exposures in loans and investment portfolios

Disclosure of downstream (Scope 3) exposures will need to improve substantially for Scope to be able to assess whether banks' climate goals can eventually contribute to their long-term sustainability. Selective disclosure of certain assets such as thermal coal and renewables investments is not sufficient to make these adjustments. Exposures are often too small to have a material impact on the credit risk profile of a bank.

For example, a study by the ECB found that banks' direct exposure to climate-sensitive sectors is relatively limited when compared to other investors, and that banks' large exposures tend to be concentrated in less carbon-intensive sectors (Figure 3). However, given the high degree of leverage in the banking sector, this does not rule out that individual banks' capital bases may be disproportionately exposed to transition risk.

Figure 3: Headline exposures to more polluting sectors appear fairly contained

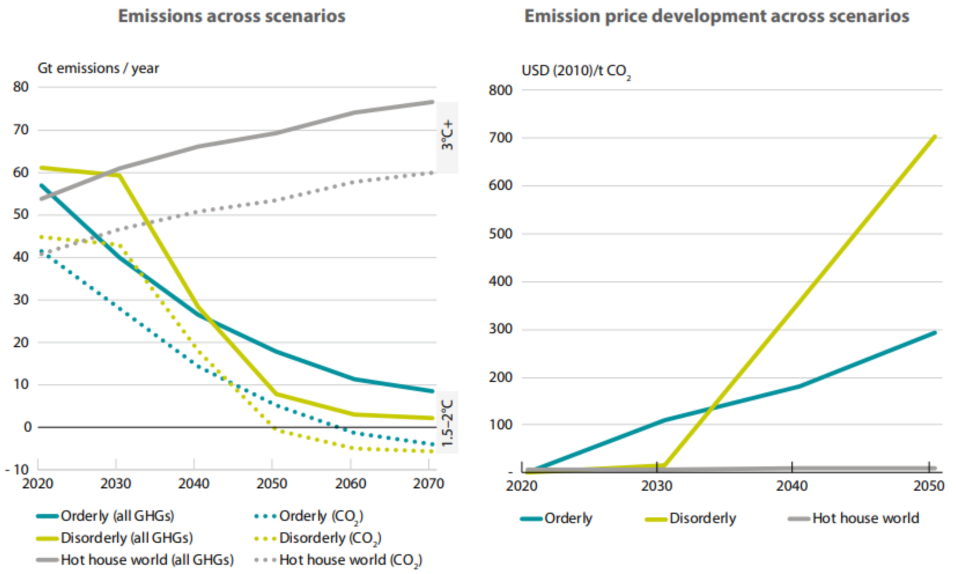


Source: ECB, taken from G20/FSB report: The Implications of Climate Change for Financial Stability, Nov 2020

Climate policies to add to challenge of managing risks

Nevertheless. a scenario analysis by the Network of Central Banks and Supervisors for Greening the Financial System (NGFS) suggests that higher carbon taxes or the lack of emissions pricing could lead to substantial shifts in the global economy beyond 2030, as could government regulation and disruptive technologies that allow for carbon capture (Figure 4).

Figure 4: Emissions and emissions pricing developments



Source: NGFS Guide to climate scenario analysis, June 2020

The overall economic uncertainty created by climate risk and climate risk policy will increase substantially in the coming years, creating a much broader challenge for banks to manage their transition risk that goes well beyond the immediate focus on physical risks and exposure to high carbon sectors.

We expect regulators to increasingly express these views when formulating stress test requirements. The latter could become key inputs into credit analysis, especially if they are combined with granular disclosure of underlying risk exposures.

Our research focuses on the approach being taken…

Given the above data constraints, we do not assess banks solely on the extent to which they are supporting sustainable growth and investment with climate goals. Instead, we focus on whether an issuer is addressing environmental issues from a risk-management or a corporate and social responsibility perspective. We also evaluate the availability and quality of disclosures on these risks.

in risk management or corporate and social responsibility

More specifically, we research questions such as:

- How potential climate change risks are being integrated into risk management frameworks
- How capabilities are being developed to meet supervisory expectations, including participation in climate stress tests
- How expertise is being developed to help clients manage the transition.

The second part of this research series will look at the S, the social factors, that Scope will start assessing as part of its bank credit analysis. The final part will cover governance factors, and provide a summary of the matrix Scope has developed around ESG risk assessments and the impact on credit ratings.

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