# Where ESG Matters for Bank Ratings

Fitch Ratings' Environmental, Social and Governance Relevance Scores (ESG.RS) communicate how ESG factors affect our credit ratings. The ESG.RS consider 14 general ESG issues for banks expressed on a '1' to '5' scale, with '1' indicating irrelevance and '5' being highly relevant for the rating. An elevated ESG.RS of '4' or '5' can be positive or negative to a rating decision, although most assigned scores reflect a negative impact.

At end-2021, Fitch had assigned ESG.RS to 950 rated banks and ESG impacts were either minimal or irrelevant to credit ratings for 83% of these. This report provides examples of banks that have been assigned elevated ESG.RS and describes how ESG issues are affecting their ratings.

**Governance Issues Dominate:** Governance is by far the single most important ESG factor in ratings assigned by Fitch to banks. All banks need to actively manage their governance risks and the minimum ESG.RS for all governance issues is '3', highlighting that governance issues are, at the very least, relevant to all bank ratings, albeit with a low impact. However, 14% of rated banks at end-2021 had at least one elevated governance score, indicating that governance concerns are credit relevant and have a negative impact on the credit ratings of these banks.

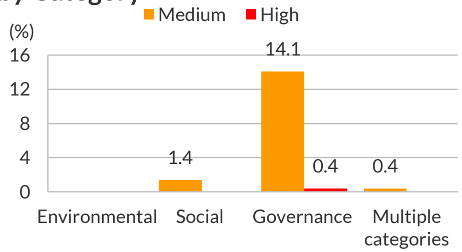
**Environmental Issues Likely to Increase:** Environmental issues do not currently affect global bank ratings, but there may be a growing number of elevated environmental ESG.RS assigned to banks over time. This is especially true for banks operating in countries where transition pathways towards low-carbon economies are shorter or in regions more exposed to extreme weather events linked to climate change.

As regulators force more disclosure around these issues and some introduce the requirement for exposures to be reported in line with science-based environmental taxonomy classifications, we anticipate that banks will need to step up their ability to manage environmental risks. This could trigger changes to strategy, business models and mitigation policies, all of which could result in credit impacts, reflected in higher environmental scores.

Efforts to require banks to report on green asset ratios could ultimately lead to greater capital charges for banks. Should this be the case, we may start to see more elevated environmental scores if Fitch believes that capital adequacy headroom has become strained.

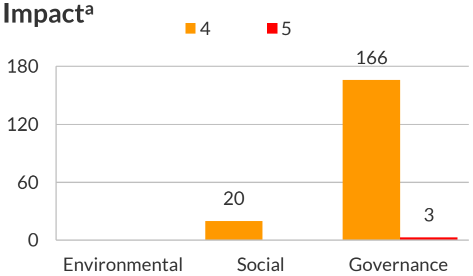
**Low Social Impact:** The impact of social issues on bank credit ratings is still very low – less than 2% of global bank ratings are affected by social considerations. However, Fitch notes some positive social impacts feeding through to ratings and include some examples in this report.

### ESG Relevance to Issuer Portfolio, by Category




[a] Above chart shows which categories are driving the highest credit impact for issuers
Source: Fitch Ratings

### ESG Elements Driving Issuer Credit Impact[a]




[a] Above chart counts the number of elements scoring '4' or '5' in each category
Source: Fitch Ratings

### ESG Relevance Scores

| Score | Relevant to sector | Relevant to issuer | Material to rating | Description |
|---|---|---|---|---|
| 5 | Yes | Yes | Key Rating Driver | Highly relevant to the rating. A Key Rating Driver that has a high impact on the rating on an individual basis. |
| 4 | Yes | Yes | Rating Driver | Moderately relevant to the rating. Not a Key Rating Driver by itself, but has a moderate impact on the rating in combination with other factors. |
| 3 | Yes | Yes | Minimal | Minimally relevant to the rating. Either has a very low impact or is actively managed in a way that results in no impact on the rating. |
| 2 | Yes | No | No | Irrelevant to the entity but relevant to the sector. |
| 1 | No | No | No | Irrelevant to the entity and irrelevant to the sector. |

Source: Fitch Ratings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## Examples of Governance Impact on Credit Ratings

### Credit Suisse Group AG (A-/Negative)

Credit Suisse Group AG has an ESG.RS of '4' for 'Governance Structure' as the group's governance issues are a contributor to the Negative Outlook. This has a negative impact on the credit profile and is relevant to credit ratings. Severe weaknesses in risk controls identified in an independent report published in 3Q21 have started to be addressed and further investments in risk-management structure are being made, but analysts consider that risk-governance weaknesses and shortcomings are appropriately reflected in an elevated governance score.

### Vietnam Joint Stock Commercial Bank for Industry and Trade (BB-/Positive)

Vietnam Joint Stock Commercial Bank for Industry and Trade (Vietinbank) is one of the four large state-owned commercial banks in Vietnam, with 64% of its listed shares owned by State Bank of Vietnam. Vietinbank has an ESG.RS of '4' for 'Governance Structure' due to the significant influence of the state on the bank's strategic objectives and a potential lack of effective independent board oversight that could weaken the protection of creditor and stakeholder rights. This has a negative impact on the credit profile, and is relevant to the ratings in conjunction with other factors. Vietinbank also has an ESG.RS of '4' for 'Financial Transparency' due to the quality and accuracy of financial reporting standards in Vietnam. Fitch believes loan classification standards among Vietnamese banks are not consistently applied, leading to systematic understating of non-performing assets. A lack of transparency can increase uncertainty and investment risks for investors and weigh on an issuer's ratings.

### Wells Fargo & Co. (A+/Negative)

The ratings of Wells Fargo & Co. (WFC) are affected by Fitch's assessment of the US bank's progress in remediating and exiting various regulatory consent orders. WFC and its rated subsidiaries have an ESG.RS of '4' for 'Management Strategy' due to the process of remediating various risk control issues and responding to regulatory findings, which has a negative impact on the credit profile and is relevant to the ratings in conjunction with other factors. WFC and its rated subsidiaries also have an ESG.RS of '4' for 'Governance Structure' to reflect the risk control and governance issues that remain outstanding and have yet to be fully addressed.

### Bulgarian Development Bank AD (BBB/Positive)

Bulgarian Development Bank AD (BDB), which is wholly owned by the Bulgarian state, faces increased governance risks related to some of its largest exposures. An inquiry was initiated in mid-2021 by the Ministry of Economy to assess whether underwriting standards applicable to certain loans comply with the bank's development mandate. BDB has an ESG.RS of '4' for 'Governance Structure' to reflect these heightened compliance risks. Fitch believes confirmation of interference in the bank's development-oriented policies could result in a weakening of its policy role and the state's propensity to support the bank, in case of failure. This could have a moderately negative impact on the bank's credit profile and is relevant to the rating in conjunction with other factors.

### Caixa Economica Federal (BB-/Negative)

Caixa Economica Federal (CEF), Brazil's third-largest bank by assets, performs a policy role in implementing government policies in the retail mortgage market. CEF is wholly owned by the federal government and Fitch believes that an increase of government influence on its management and strategy could negatively affect creditors' rights given the government's proven ability to influence the policies of the banks it controls. This has a moderately negative impact on CEF's ratings in conjunction with other factors, reflected in an ESG.RS of '4' for 'Governance Structure'. CEF also has an ESG.RS of '4[+]' for 'Community Relations, Social Access, Affordability' (a Social issue) as its public-sector ownership supports its ability to attract low-cost retail deposits, while its policy role ensures it retains a dominant position in the low-income retail mortgage market. These factors considerably boost CEF's franchise, strengthen its credit profile and have a moderately positive impact on its ratings in conjunction with other factors.

## ESG Relevance Scores – Governance Issues Assessed

**Governance (G)**

| General issues | Sector-specific issues | Reference |
|---|---|---|
| Management & Strategy | Operational implementation of strategy. | Business Profile |
| Governance Structure | Board independence and effectiveness, ownership concentration; protection of creditor/stakeholder rights, legal/compliance risks, business continuity, key person risk, and related-party transactions. | Business Profile |
| Group Structure | Organisational structure, appropriateness relative to business model, opacity, intra-group dynamics and ownership. | Business Profile |
| Financial Transparency | Quality and timing of financial reporting, and auditing process. | Business Profile |

Source: Fitch Ratings

## Examples of Social Impact on Credit Ratings

The ratings of banks are rarely affected by social issues, something which is more prevalent among non-bank financial institutions potentially subject to lighter regulation or operating in sectors which can attract more political and public scrutiny. However, there has been a growing number of cases where analysts have identified 'Human Rights, Community Relations, Access & Affordability' and 'Exposure to Social Impacts' as issues that have a positive influence on banks' credit ratings. Positive impacts arising from social lending policies, for example, can support banks' franchises, which feeds through to the ratings.

### Freddie Mac and Fannie Mae (both 'AAA'/Negative)

Freddie Mac and Fannie May are US government-sponsored entities (GSEs) that play a core role in the country's housing finance market. Both have an ESG.RS of '4[+]' for 'Human Rights, Community Relations, Access & Affordability' because their public policy missions of providing liquidity, stability and affordability to the US housing markets are key ratings drivers and make up a big part of the rationale for equalising their ratings with those of the US sovereign.

Other US GSEs with similar positive ESG.RS are **Farm Credit System** (AAA/Negative), **AgFirst Farm Credit Bank; Agribank, FCB; CoBank, ACB;** and **Farm Credit Bank of Texas** (all AA-/Stable) to reflect the extent to which farm lending in the US, which Fitch views as a key social service, is supported by these entities and for which they would likely receive sovereign support. The likelihood of this support has a positive influence on the issuers' credit profiles.

### BNG Bank N.V. (AAA/Stable)

BNG Bank N.V. is the larger of the two Dutch policy banks. It has a clear, strategic and long-established role to provide banking services and financing to public authorities. BNG has an ESG.RS of '4[+]' for 'Human Rights, Community Relations, Access & Affordability' as Fitch believes the bank fulfils a critical role in financing housing associations at low cost and therefore contributes at the implementation of state social policy to improve affordability for underserved communities to the Dutch housing market. This factor has a moderately positive impact on our assessment of a high likelihood of support from the Dutch state, in conjunction with other factors.

### Triodos Bank N.V. (BBB/Stable)

Triodos Bank N.V. is a Dutch bank that focuses on financing social, environmental and cultural change. It has expanded its sustainable mortgage loan book and the bank has longstanding expertise in financing projects in renewable energy, healthcare, sustainable commercial real estate and social housing. The bank's distinct client proposition in lending and asset management has allowed Triodos to largely avoid competing on price and has helped it build a stable and granular funding base. Triodos has an ESG.RS of '4[+]' for 'Exposure to Social Impacts' reflecting the moderately positive impact on the bank's business profile, and rating, arising from its long-term focus on sustainability and social-related financing and investing.

### Fondo Mivivienda S.A. (BBB/Stable)

Fondo Mivivienda S.A. in Peru is to the US GSEs and also has an ESG.RS of '4[+]' for 'Human Rights, Community Relations, Access & Affordability'. Mivivienda is a government-owned bank that performs a key role in supporting government policies to ensure low-income individuals have access to low-cost housing. This social positioning has a moderately positive impact on its credit profile, in conjunction with other factors.

### Banco de Desarrollo Rural, S.A. (BB-/Stable)

Banco de Desarrollo Rural, S.A. (Banrural) has an ESG.RS of '4[+]' for 'Human Rights, Community Relations, Access & Affordability' reflecting a moderately positive impact on the bank's franchise arising from its focus on the provision of services for underbanked and underserved communities in Guatemala. Banrural's lending is heavily weighted towards the retail sector, SMEs and microfinance sectors, which together represented about two-thirds of loans, and the bank has leading positions in microfinance lending, SME finance and consumer credit. The bank's focus on community finance is a strong differentiating factor, which supports its franchise and credit rating.

### ESG Relevance Scores – Social Issues Assessed

**Social (S)**

| General issues | Sector-specific issues | Reference |
|---|---|---|
| Human Rights, Community Relations, Access & Affordability | n.a. | n.a. |
| Customer Welfare – Fair Messaging, Privacy & Data Security | Fair lending practices, pricing transparency, repossessions/ foreclosure/collection practices, consumer data protection, legal/ regulatory fines stemming from any of the above. | Operating Environment, Risk Profile, Asset Quality |
| Labour Relations & Practices | Impact of labour negotiations, including board/employee compensation and composition. | Business Profile, Earnings & Profitability, Capitalisation & Leverage, Funding |
| Employee Wellbeing | n.a. | n.a. |
| Exposure to Social Impacts | Shift in social or consumer preferences as a result of an institution's social positions, or social and/or political disapproval of core activities. | Business Profile, Earnings & Profitability |

Source: Fitch Ratings

## Examples of Environmental Impact on Credit Ratings

Exposure to environmental risks is currently not a material rating driver for rated banks but management of environmental issues is becoming increasingly important as stakeholders and regulators focus more on evaluating and understanding climate change risks. Banks are dedicating increased resources to boost in-house knowledge of environmental issues, embed climate change into risk management systems and gather relevant data.

Banks' fairly well-diversified loan and investment portfolios, plus such mitigating factors as insurance cover, mean that physical risks from climate change associated with extreme weather events are generally not sufficient to have a material impact on a bank's rating. As regulation around balance-sheet greening evolves, banks will face increased transitional risks from climate change, which may require business model and other adjustments. Regulatory timetables and prudential requirements vary across region and it may be that transition risk impacts fall well beyond the much shorter three- to five-year horizons captured by Fitch's credit ratings.

Nevertheless, there are isolated instances where environmental issues have affected bank ratings and analysts have adopted a portfolio approach, assigning non-standard ESG.RS for 'Exposure to Environmental Risks' to some banks. This is the case for banks operating in geographies more exposed to extreme weather events. For example, **Kenyan** banks are scored '3' for this factor because the performance of farming loans, which are material for Kenyan banks, is vulnerable to locust plagues, affected by extreme environmental conditions.

## ESG Relevance Scores – Environmental Issues Assessed

**Environmental**

| General issues | Sector-specific issues | Reference |
|---|---|---|
| GHG Emissions & Air Quality | Regulatory risks, emissions fines or compliance costs related to owned equipment, which could affect asset demand and profitability. | Operating Environment |
| Energy Management | Investments in or ownership of assets with below-average energy/fuel efficiency, which could reduce future valuation of these assets. | Risk Profile |
| Water & Wastewater Management | n.a. | n.a. |
| Waste & Hazardous Materials Management, Ecological Impacts | n.a. | n.a. |
| Exposure to Environmental Impacts | Impact of extreme weather events on assets and/or operations and corresponding risk appetite and management, catastrophe risk, credit concentrations. | Business Profile, Asset Quality |

Source: Fitch Ratings

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