

# S&P MI approach to ESG factors and PD calculation - Sustainability and Credit Risk in a Changing Regulatory Landscape

ABI Event  
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Milan

**Risk, meet  
opportunity.**



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# Significance of Environmental, Social, Governance (ESG) in Credit Risk

## The European Banking Authority (EBA)

Published its roadmap outlining the objectives and timeline for delivering mandates and tasks in the area of sustainable finance and ESG risks. The 3yr roadmap explains the EBA's sequenced and comprehensive approach to integrate ESG risks considerations in the banking framework.

Source: EBA Roadmap on sustainable finance, EBA, As of: 13 Dec 2022.

## Bank of Italy

“La funzione di Risk Management incorpori i fattori climatici e ambientali nella valutazione dei rischi e monitoraggio elaborando report su tipo e livello di materialità [...]”.

Source: Guidelines on loan origination and monitoring, EBA, As of: 29 May 2020.

## Basel Committee on Banking Supervision (BCBS)

Basel Committee on Banking Supervision (BCBS), issued a set of FAQs that clarify how climate risks may be captured. BCBS said banks should “integrate climate-related financial risks either in their own credit risk assessment or when performing due diligence on external ratings.”

Source: Frequently asked questions on climate-related financial risk, Basel Committee on Banking Supervision. As of: 8 Dec 2022.

## European Parliament and of the Council

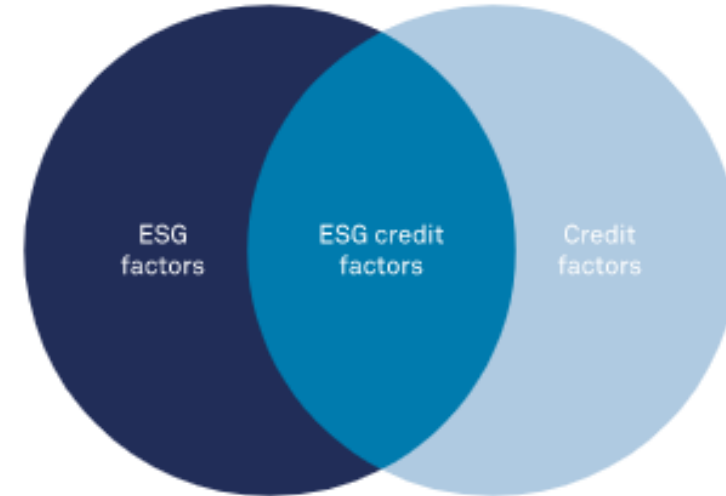
“Financial market participants should be required to disclose specific information regarding their approaches to the integration of sustainability risks and the consideration of adverse sustainability impacts”

Source: Regulation (EU) 2019/2088 of the European Parliament and of the Council on sustainability-related disclosures in the financial services sector – SFDR, As of: 27 Nov 2019.

# The Intersection of ESG & Credit

- “They (ESG credit factors) have **always** played a prominent role in creditworthiness and, thus, in our credit ratings – **even before** the term ESG was coined more than a decade ago”. *Source: ESG in Credit Ratings, S&P Global Ratings*
- Not all ESG factors materially influence creditworthiness.
- ESG credit factors are those ESG factors that can materially influence the creditworthiness of an entity and for which there is sufficient **visibility and certainty**.
- ESG factors do not always correlate to ESG credit factors – e.g. cement producers negative environmental impact is not generally considered credit-negative.

The Intersection Of ESG And Credit



ESG--Environmental, Social, and Governance. Source: S&P Global Ratings. Copyright © 2021 by Standard & Poor's Financial Services LLC. All rights reserved.

Source: “ESG - Environmental, Social, And Governance Principles In Credit Ratings’ Oct 10, 2021”, S&P Global Ratings.

# ESG Credit Indicators

- ESG credit indicators provide **additional disclosure and transparency** at the entity level and reflect S&P Global Ratings' opinion of the influence that ESG factors have on credit rating analysis.
- They are **not a sustainability rating** or ESG evaluation.
- The extent of the influence of these factors is reflected on an alphanumeric 1-5 scale

## ESG Credit Indicators

### Influence on credit rating analysis

	Environmental credit indicator	Social credit indicator	Governance credit indicator
Positive	E-1	S-1	G-1
Neutral	E-2	S-2	G-2
Moderately negative	E-3	S-3	G-3
Negative	E-4	S-4	G-4
Very negative	E-5	S-5	G-5

Source: S&P Global Ratings.

**Learn how material** the influence of ESG credit factors is on the various analytical components during S&P Global Ratings analysis.

**Environmental credit factors** include climate transition risks, physical risks, and natural capital.

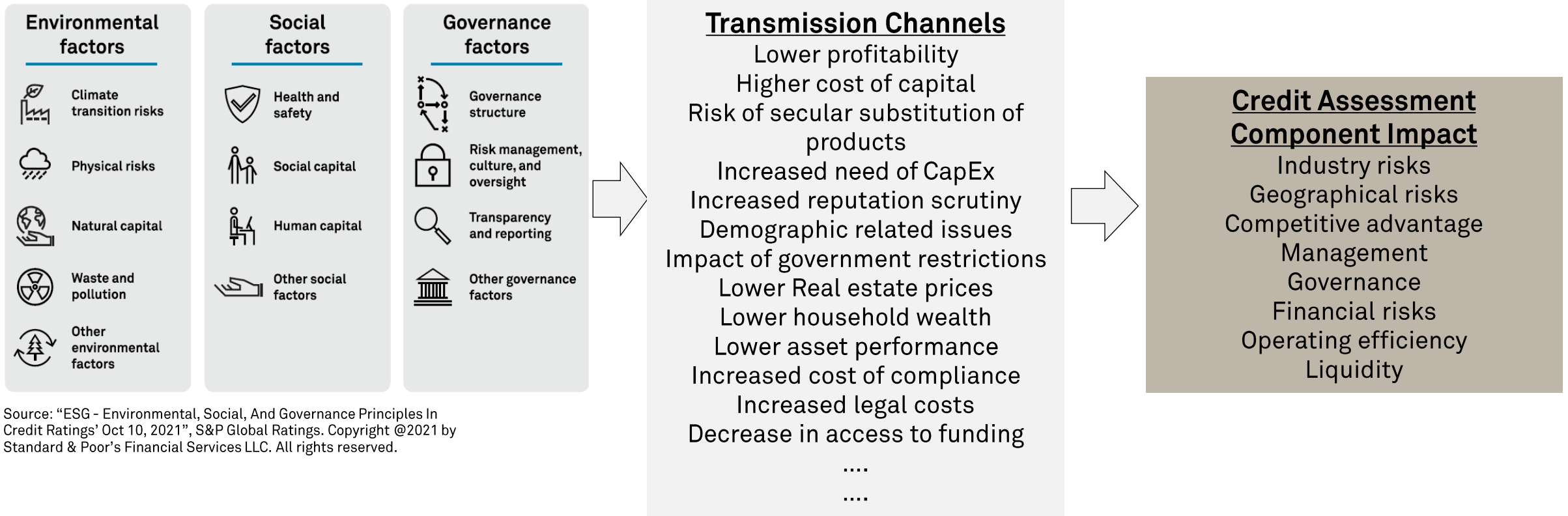
**Access social credit factors** including health and safety, and social and human capital.

**Access governance credit factors** including governance structure, risk management, transparency, and reporting.

Source: "How ESG Factors Impact Credit Risk. S&P Global Ratings. As of: January 26, 2022.

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# Key ESG Credit Factors & Transmission Channels to Credit Assessments



Source: "ESG - Environmental, Social, And Governance Principles In Credit Ratings' Oct 10, 2021", S&P Global Ratings. Copyright @2021 by Standard & Poor's Financial Services LLC. All rights reserved.

# ESG Credit Factors Are Important – Examples

## Environmental factors

-  Climate transition risks
-  Physical risks
-  Natural capital
-  Waste and pollution
-  Other environmental factors

- **Royal Dutch Shell PLC downgraded from AA- to A+ (Feb' 21) – on increasing risks from the energy transition and weak industry profitability**

## Social factors

-  Health and safety
-  Social capital
-  Human capital
-  Other social factors

- **Delhi International Airport Ltd. upgraded from B- to B (May' 22) – on easing of Covid restrictions and higher capacity on domestic airlines.**

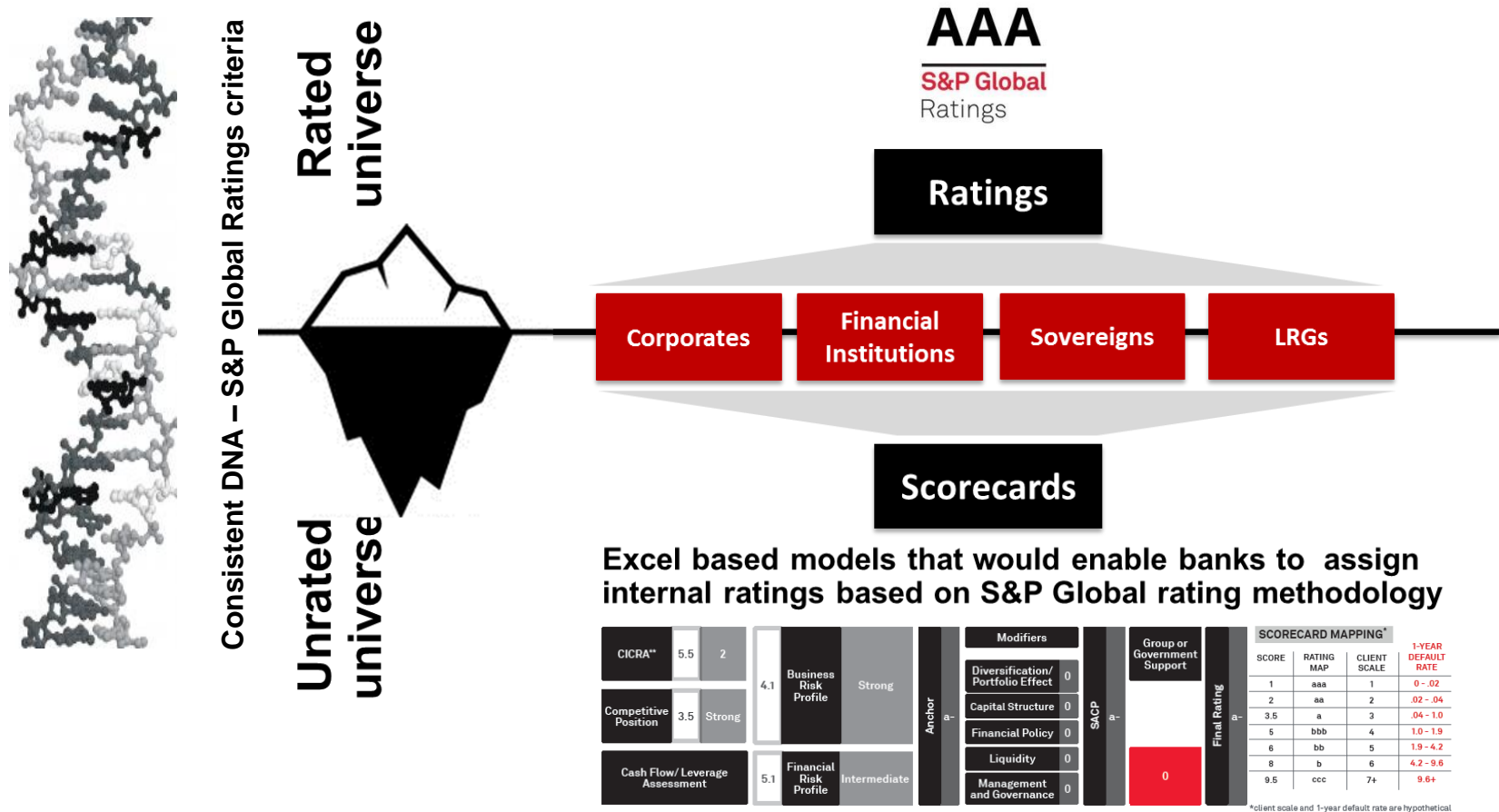
## Governance factors

-  Governance structure
-  Risk management, culture, and oversight
-  Transparency and reporting
-  Other governance factors

- **Volkswagen AG downgraded from A to A- (Oct' 15) – Diesel emission scandal demonstrated material deficiencies in its management and governance and general risk management framework.**

# What is a Credit Assessment Scorecard?

Scorecards allow to manage unrated exposures using a consistent “risk language”





# What is a **Credit Assessment Scorecard with ESG Factors**?



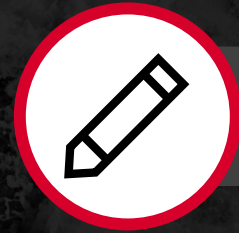
Tool to assess:  
**ESG Credit Indicators**, and  
their influence on credit quality



Includes detailed **ESG Sector  
Factors**



Broadly aligned with **S&P Global  
Ratings criteria and ESG  
Principles**



**Well-documented and  
transparent**



Coverage of **multiple sectors and  
geographies**



**Excel-based**



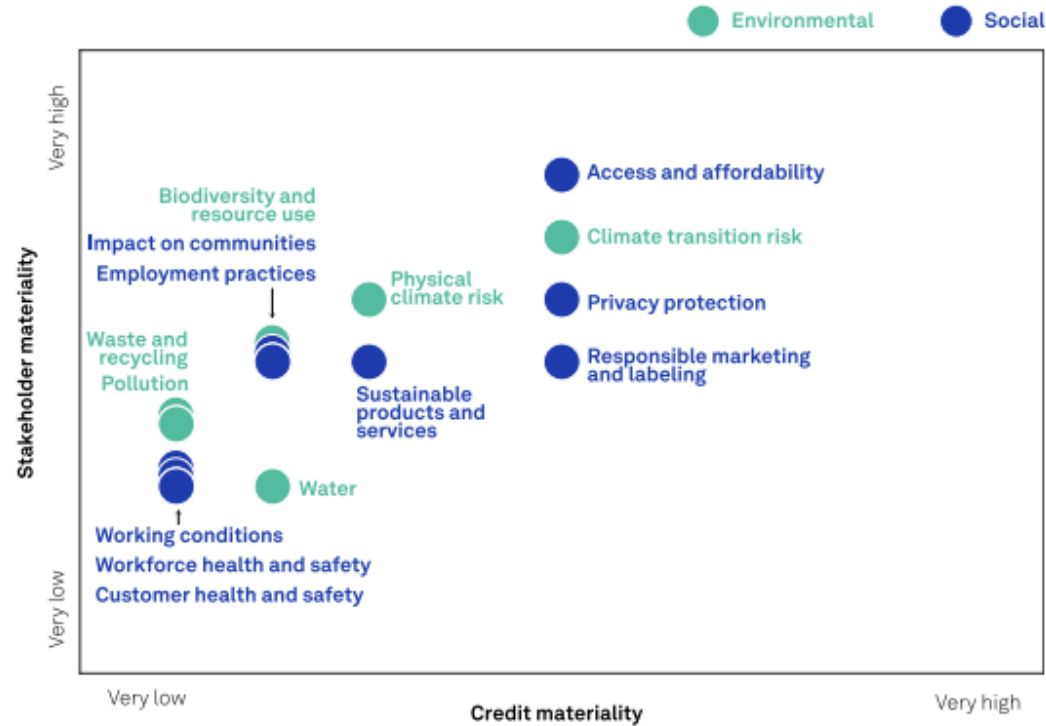
# ESG Credit Factors within Banks Credit Risk

# ESG Risks Are Key Drivers of Banks Creditworthiness

‘Climate’ and ‘Social’ risks are growing issues...

....while ‘Governance’ deficiencies weighs negatively the most on the banking sector.

## ESG Materiality Map For The Banking Sector



Source: ESG Research. ESG Materiality Map. Banks. S&P Global Ratings. As of: July 20, 2022.

## Key Governance Factors Distribution – Global Banks



Sources: S&P Global Ratings. Copyright © 2022 by Standard & Poor's Financial Services LLC. All rights reserved.

Source: ESG Credit Indicator Report Card: EMEA Banks, S&P Global Ratings. As of: Jan 19, 2022.

# ESG credit factors in our Banks Credit Assessment Scorecard

- ESG credit factors can simultaneously influence multiple areas of the credit analysis.
- Areas most likely influenced by ESG considerations include **BICRA, Business and Risk Position**.

Bank Name:	Citigroup Inc.	Date of Analysis:	15 December 2022							
Bank's Home Regulator	United States	FC Sov. Rating	AA+	Act as ceiling?	YES					
BICRA Group	3	Economic Risk	3	Industry Risk	3					
MACRO FACTORS		BANK SPECIFIC FACTORS			EXTERNAL SUPPORT					
Weighted-average Economic Risk	ANCHOR	Business Position	Capital and Earnings	Risk Position	Funding and Liquidity	STAND ALONE	Group	Government	Alac	FINAL SCORE
Industry Risk		1	0	0	0		a-	0	0	

Source: S&P Global Market Intelligence Banks Scorecard, As of: Dec 2022

- Our ESG Credit Metrics are displayed on a continuous scale from 1 to 5 (1 is considered positive to 5 very negative).

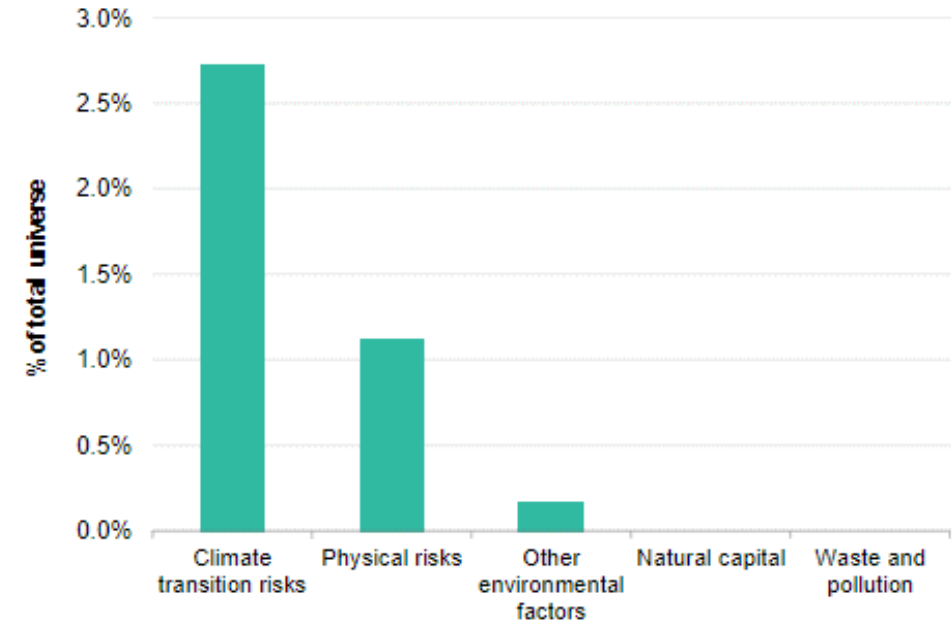
	Positive	Neutral	Moderately Negative	Negative	Strongly Negative
ESG Credit	1	2	3	4	5
e		e-2			
s			s-3		
g		g-2			

# Banks Scorecard and ESG

## Environmental 'E' - limited influence on our credit rating analysis of banks

- **Physical Risk:** geographical location of a bank's assets and the materiality of environmental factors.
  - Example: Some countries are regularly adversely affected by natural disasters, such as hurricanes and earthquakes, that cause significant damage to critical infrastructures and disrupt economic activity.
- **Climate transition risks:** higher for banks exposed to economic sectors sensitive to climate change.
  - Example: bank with a high concentration of customers in the oil and gas sector is more vulnerable to shifts in policies and to climate change, even if this risk is not material at country or sector level.

Key Environmental Factors Distribution - Global Banks



Source: S&P Global Ratings.

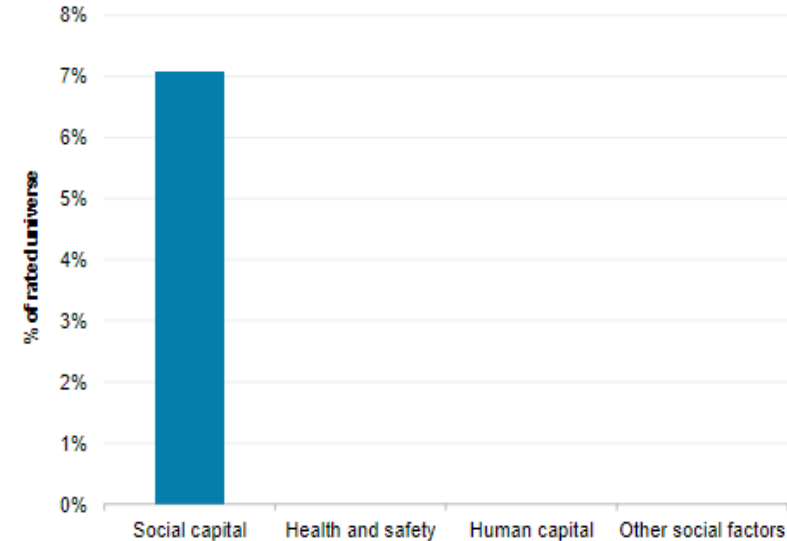
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# Banks Scorecard and ESG

## Social 'S' – positive and negative implications

- The influence of social factors is usually bank-specific instead of country-specific.
- The positive influence of social factors could stem from the specific function that some banks play in the economy. For example, some GRE entities have a public mission (e.g. microfinance, social housing, infrastructure financing).
- Social factors could also have a **negative influence** in our bank analysis. For example, we view banks with a high proportion of lending to subprime customers as more exposed to social factors, as they usually face heightened compliance, reputational, and regulatory risks.

Key Social Factors Distribution - Global Banks



Source: S&P Global Ratings.

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# Banks Scorecard and ESG

Governance 'G' - usually relate to weak governance and transparency

- Governance-related risks usually relate to weak **governance and transparency**.
- We first analyze the governance at the system level through the **'institutional framework' sub score**.
  - This assessment is based on the analysis of the following 3 factors:
    - banking regulation and supervision,
    - regulatory track record,
    - and governance and transparency.

Then, we incorporate bank' specific elements.

Key Governance Factors Distribution - Global Banks



Sources: S&P Global Ratings.

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# Banks Scorecard and ESG

## Governance 'G' - usually relate to weak governance and transparency

- Banks are subject to a higher level of regulation and supervision than most other economic sectors, meaning that the quality of their governance tends to be overall stronger.
- We should also analyze the quality of the governance at the individual bank level:
  - Negative **political influence** from the government (GRE) is another cause for weak governance assessment, evidently reflected in Argentinean bank and Bolivian bank.
  - **Money laundering** is a key operational risk for banks globally, but European banks are currently over-represented. Anti financial crime (AFC) issues expose **internal control and organizational failures**, as the risk of large fines and remediation costs could hamper earnings or capitalization, and ultimately cause reputational or franchise damage. Examples are: Danske Bank, Swedbank.
  - **Weak governance structure**, as seen for loose cooperative networks. Example: Iccrea Banca, Savings Banks of Finland
  - Constant **Managerial and Strategy changes**. Examples: Deutsche Bank, De Volksbank NV
  - **Weak governance compliance and risk management (e.g. Wells Fargo)**. This might also result in material reputational scandals and negative newsflow (e.g. **Credit Suisse**).

# Banks Scorecard and ESG

## Governance 'G' – Quantifying the impact

- **Step 1.** Link to S&P Ratings 'Institutional Framework' to assign the **baseline** 'Governance' score\*. For example, Argentina 'Institutional Framework' of 'High' will map to 'g-3' (on a scale from g-1 to g-5) baseline.

### Handbook - Scoring Guideline - Governance

	Governance structure	Risk management, culture and oversight
Below average	The entity shows limited checks and balances in decision-making processes such as oversight over senior management. ....	Management shows limited sensitivity to emerging and existing risks and opportunities. ....
Above average	Governance and conduct standards compare positively with the industry average. ....	Robust risk management framework and culture than the wider banking sector. ....

Country	Institutional framework	
Argentina	High	5
Armenia	Very High	7
Azerbaijan	Extremely High	10
Bangladesh	Extremely High	10
Belarus	Extremely High	10
Bolivia	Very High	7
....	....	....

Source: S&P Global Market Intelligence Generic Banks Scorecard and Guidelines with ESG Credit Metrics. For illustrative purposes only.

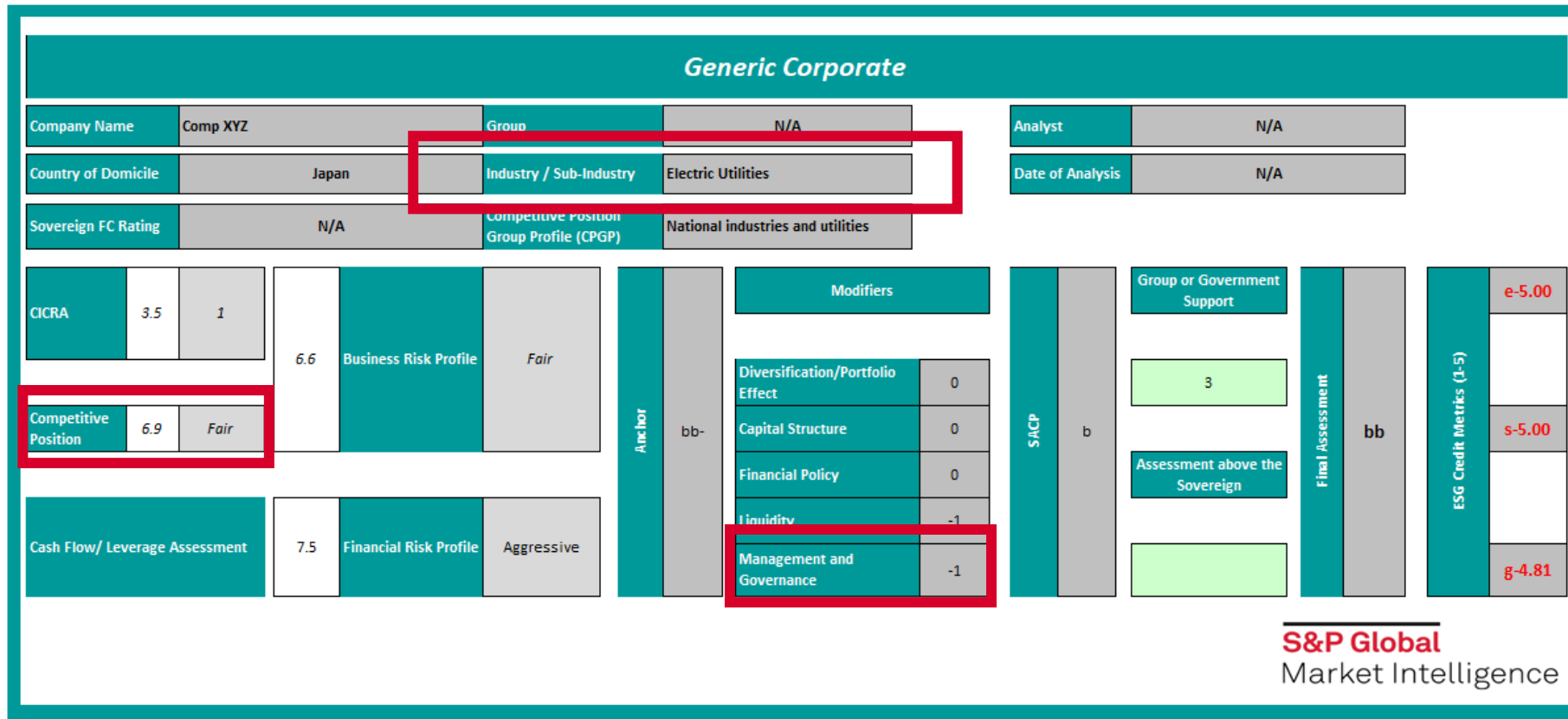
- **Step 2. Entity Specific analysis** to incorporate credit-relevant deficiencies at entity level. Basically, the scorecard will penalize or benefit the banks only in those cases where the ultimate G score differs from the baseline.

Governance, management, and strategy	Baseline	Final	
Management & Corporate Strategy	g-3	g-4	Below Average

# ESG Everywhere

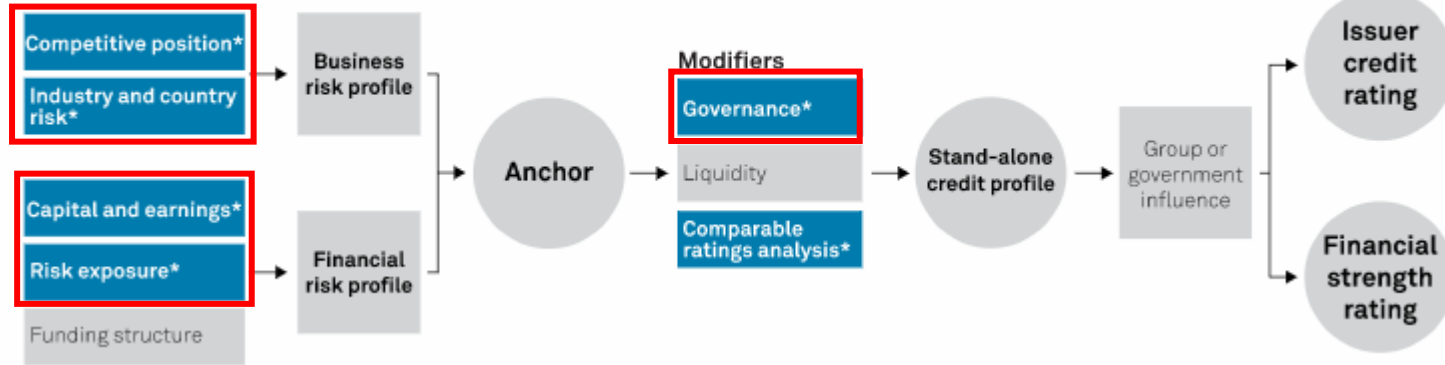
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- Areas most likely influenced by ESG considerations include Industry risk, Competitive position and Management/Governance.



# ESG Credit Factors Impact All Asset Classes

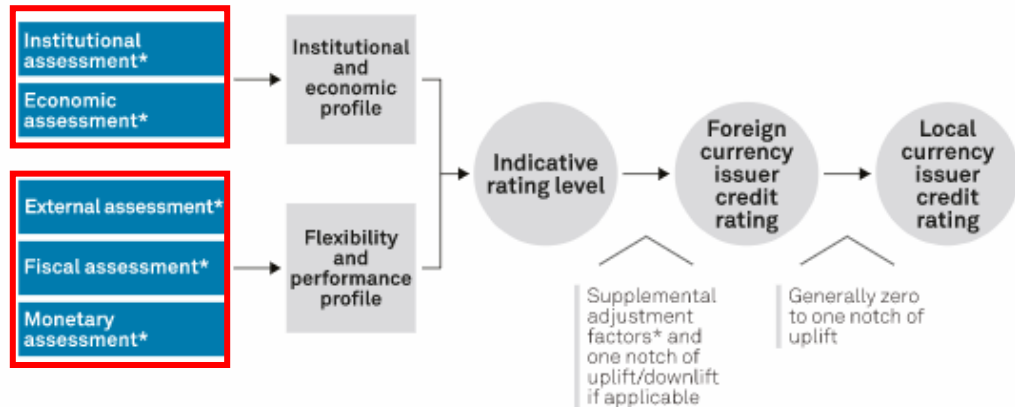
## Insurance Criteria Framework



## • Insurance

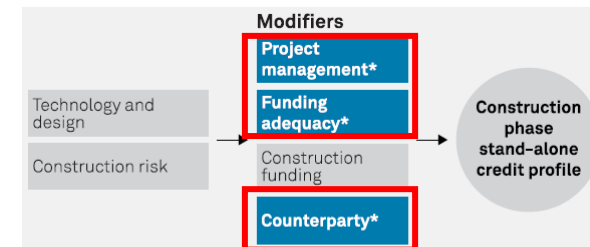
## Sovereigns

### Sovereign Criteria Framework

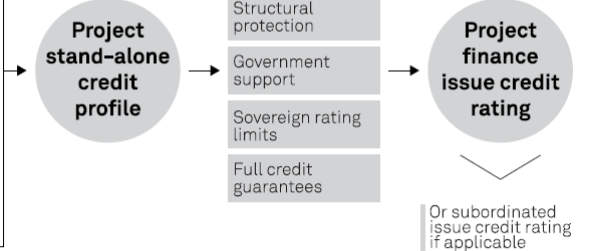
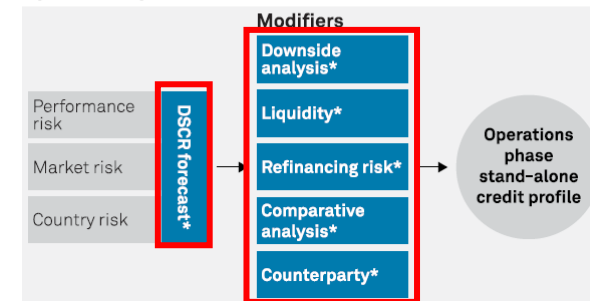


## Project Finance

### Construction profile



### Operations profile



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# ESG in Credit Risk: Developments

Specific actions for corporate loan analytics and credit risk management



Clarify methodological approach and train credit analysts

- Define ESG credit risk factors
- Introduce ESG sector materiality
- Integrate ESG more structurally and transparently in the credit assessment

Ensure consistency of definitions, data and models

- Clarify connection between credit and ESG assessments
- Shifting focus of assessments on the overall sustainability of borrowers' business models

Enhance models, data and criteria as new evidence becomes available

- Build robust and flexible methodological framework to evolve over time

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# Thank You

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