PRI Principles for Responsible Investment

ESG IN CREDIT RISK AND RATINGS: BRINGING ANALYSTS AND ISSUERS TOGETHER

BANKING SECTOR WORKSHOP - NORTH AMERICA

GORDON AND BETTY MOORE FOUNDATION

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United Nations Global Compact

An investor initiative in partnership with UNEP Finance Inititaive and UN Global Compact

NOTES FROM THE WORKSHOP

The PRI's ESG in credit risk and ratings initiative is bringing voices from the corporate side into the conversation on how to better incorporate environmental, social and governance (ESG) factors into credit risk analysis. This article summarises the key points from a workshop held with North American banks, bringing together their representatives, investors and credit rating agencies. This workshop is the fourteenth of the series Bringing credit analysts and issuers together, which promotes a transparent and systematic consideration of ESG factors in credit risk assessment.[1]

The 10 March 2022 workshop attracted 30 market participants, including six representatives from four Canadian and US banks (see Figure 1 below), four representatives from three credit rating agencies (CRAs), and 14 investors from 13 firms (see Appendix for the full list of participating organisations). The discussions were held under the Chatham House Rule and were structured around a set of guidelines that were circulated to participants prior to the event and tailored to the sector.[2]

Figure 1: Participating Canadian and US banks

Companies	
Bank of America	Citigroup
BMO	Wells Fargo

This workshop followed two other events with a similar focus –featuring financial institutions from the European Union (EU) and the United Kingdom (UK).[3] North American banks have recently been ahead of European peers in terms of valuations and profitability; they are less fragmented and have been faster to address the problems left by the financial crisis of a decade ago.[4]

When it comes to ESG consideration, however, they have lagged Europe, partly reflecting slower regulatory uptake of rules and requirements on ESG disclosure, especially incorporating the effects of climate change into risk management frameworks.[5]

Things are changing though. Indeed, sustainable finance regulation dominated discussion at the workshop. Furthermore, while incorporating environmental issues in banking practices has lagged in Canada and the US, the social pillar has become more prominent than in Europe due to a relatively more robust consumer protection legal landscape. As a result, concerns around mis-selling,

[1] The workshops series follows a string of 21 roundtables organised for institutional investors' credit analysts and CRA representatives between 2017 and 2019. The discussions are documented in the trilogy, Shifting perceptions: ESG, credit risk and ratings.
[2] The PRI initially published these guidelines after the Paris workshop, the first of the series. They will be refined as the workshops continue.
[3] Read the EU and UK banking sector workshop summaries.
[4] Reuters (30 September 2021), European banks need regulation reset to catch U.S. rivals, Botin says.
[5] Thomson Reuters Regulatory Intelligence (2021), ESG: Fast-emerging challenges for financial institutions.

mislabelling and transparency are significant and relevant to credit risk analysis. As stated by one CRA, while this is not a new issue, it can now be framed as a social factor in risk management processes. Moreover, one CRA representative and one investor also mentioned the importance of inclusive financial product distribution, and of community engagement in the development of products that are customised to client needs.

This report contains highlights from the workshop, which was convened with the objectives of:

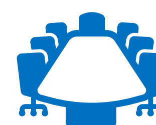
- promoting consensus around credit-relevant ESG issues in the North American banking sector;
- aligning expectations around sustainability considerations (e.g. financially material ESG factors, ESG questionnaires, ESG disclosures, impact on balance sheets);
- improving communication between credit analysts and companies.

Several observations were common to those in previous workshops, therefore this report focuses mostly on new and/or banking sector-specific credit-relevant themes. This article also highlights some emerging solutions that participants are considering.

Key discussion findings are grouped into three main areas, as follows:

1. Governance: building a track record
2. Climate risk: the challenges of measuring financed emissions
3. Sustainable finance regulation: expectations and concerns

1. GOVERNANCE: BUILDING A TRACK RECORD



CRAs and investors have long understood the relationship between governance and creditworthiness, where good governance can underpin a strong credit profile.

> “Governance is the most important of the ESG pillars and probably the least quantifiable.” – CRA

Feedback from most participants confirmed that traditional governance factors for North American banks continue to be the focus of credit analysis, specifically metrics related to:

- risk management strategy;
- management credibility and track record;
- organisational structure;
- board structure and independence;
- regulation compliance;
- litigation mitigation; and
- reporting and transparency.

The relevance and the financial materiality of governance metrics varies depending on various operational factors, such as the bank’s size, its business model and its presence in different jurisdictions. The interplay between governance metrics and operational factors is typically reflected in

assessment weightings, which vary among institutions. Additionally, participants noted that most credit analysts remained reliant on ESG information providers to collect primary data on various issues, including governance ones. This can be problematic because the data and/or scores by ESG information providers are not necessarily credit relevant.

Furthermore, both CRAs and investors emphasised the importance of senior management involvement when filling in data gaps and ensuring the veracity, reliability and transparency of reported information. Without this level of commitment, corporate greenwashing is more likely.

> “Relying on reported data is not enough. Face-to-face meetings are important to make sure that information reported by banks is reliable and backed by concrete actions to avoid corporate governance greenwashing.” – Investor

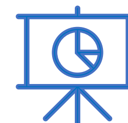
Even though the governance risk assessment process is highly dependent on qualitative information, it is a robust process capable of producing reliable and comparable data. At the CRA level, this reliability results from the extensive and historic use of traditional corporate governance metrics in credit risk assessment. CRAs have a sufficient track record of performance data to effectively quantify the risks and anticipate their impact on the probability of issuer default. According to different CRA and investor participants, similar results are expected for emerging ESG risks such as cybersecurity and climate risks, particularly as more data becomes available and regulatory requirements increase. This explains why many participants thought that it is critical to establish a year-to-year track record, even if a lot of data is still fragmented.

> “It took many years to develop a mature way to look at credit risk, and so we will take many years to develop a mature way to look at ESG factors. It is part of the process, and guidance from governments is essential in this process.” – CRA

EMERGING SOLUTIONS

Whilst this is already an existing practice, participants mentioned that periodic meetings with banks’ senior management and C-suite representatives are a good way for investors and CRAs to keep updated on companies’ overall governance performance.

2. CLIMATE RISK: THE CHALLENGES OF MEASURING FINANCED EMISSIONS



Some of the participating banks indicated that they are conducting due diligence on physical and transition climate risks, using a sector-based approach to collect data that highlights client exposure to these risks. This sector-based approach prioritises analyses of organisations in sectors that are more carbon intensive and/or have a high vulnerability to climate-related physical risk.

“We have to start collecting data now to have a year-to-year track record in the future.” – Corporate borrower

Regarding transition risk, banks are looking at their clients’ carbon emission reduction commitments, information on their ability to comply with those commitments (e.g. personnel with the right set of skills) and information to assess companies' ability to deliver and meet targets. As for physical risks, banks are exploring climate scenario analysis, despite the limitations on the usefulness of resulting data. Participants noted that, although climate risks must be factored into all risk assessments, the limitations on such analysis (data inconsistencies and a lack of clear, relevant definitions) make it difficult for financial institutions to understand how climate risk affects banks’ creditworthiness.

Moreover, because many companies still do not measure their carbon footprint, calculating financed emissions from a bank portfolio is difficult. To address this challenge, two banks have started gathering sector-specific data from information providers to use as a proxy. Nonetheless, they hope to be able to quantify their financed emissions on a company-by-company basis in the future – which is even more challenging given that companies within the same sector have different exposures to climate risks based on factors such as their business model (e.g. energy companies with different energy mixes), climate transition strategies and geographical location.

“Just because a sector is more exposed to climate risk does not mean that all companies in that sector face the same amount of risk.” – CRA

CRA participants agreed that climate risk is becoming more relevant, and that banks should incorporate information about physical and transition risks into their client assessments when offering a loan. For that reason, CRAs are strengthening their own methodologies to allow for a more systematic consideration of climate risks in banks’ assessment process.

Agricultural banks and small banks located in hurricane-prone areas were mentioned as two concrete examples of where physical climate risks could become financially material in the near term. For many workshop participants, the banks’ portfolio diversification, especially for the large investment banks, should help mitigate most transition and physical climate risks, due to different transition pathway timeframes for different sectors and regions.

“Even though the largest six banks in Canada invest heavily in oil and gas, their exposure to climate risk is still very limited due to their large loan portfolios.” – CRA

EMERGING SOLUTIONS

- More innovative approaches to measuring carbon emissions are being developed, which will improve data credibility and reliability.
- One CRA shared that it is useful to look at the percentage of OpEx and CapEx in a green or social bond’s use of proceeds to determine whether the company is delivering on its commitments.
- Examining how rising carbon prices in Canada affect businesses and their carbon transition strategies can help all market players better understand how climate transition risks can materialise in different sectors.

3. SUSTAINABLE FINANCE REGULATION: EXPECTATIONS AND CONCERNS

Participants discussed the evolving regulatory landscape around climate change risks, including the principles that the Basel Committee on Banking Supervision will soon establish, with the goal of effective climate risk management and supervision at all risk levels. In this regard, two US banks explained that they regularly engage with the Office of the Comptroller of the Currency (OCC) at the US Treasury to better understand the latest expectations on incorporating climate risks into their risk assessments. This iterative approach differs from the EU and the UK, which have already begun to implement climate-specific regulations.

Given the level of uncertainty surrounding the financial implications of physical and transition climate risks for financial institutions, some participants expressed that the approach of the US – iterative engagement before implementing prescriptive measures – is more prudent. Despite this, workshop participants appeared to agree that regulation and standards relating to sustainable finance will be important in improving climate risk assessment models because they have the potential to improve data accessibility, reliability, consistency and comparability. This could promote a better understanding and quantification of climate risk implications in credit defaults. Specifically, one bank stated that a US taxonomy would be extremely useful to promote data comparability.

Regarding climate stress testing, some workshop participants expressed concerns regarding scenario analyses, because these tools are still in early stages of development. Participants fear that inadequate climate scenario analysis could harm banks' efforts to support clients in their energy transition.

“Because the tools are so new, incorporating climate stress testing into regulatory capital stress testing may be premature.

We need to give these tools more time and flexibility to develop.” – Corporate borrower

Two investors also shared their concern about disclosure harmonisation. Although they recognise its advantages, they believe that different approaches may be necessary to reduce potential unforeseen risks. One of the investors, for example, mentioned that they preferred the liquidity injection approach taken by the US in response to the 2008 financial crisis (i.e. massive purchases of securities, including US Treasuries), as opposed to the one chosen by the EU (i.e. shorter term repurchase agreements).

EMERGING SOLUTIONS

One bank stated that, to deal with the proliferation of different taxonomies, the bank is developing a standardised climate scorecard and risk assessment framework, which will include a common set of questions and criteria for assessing climate risks across all jurisdictions. Nonetheless, some customisation will still be required.

APPENDIX

Figure 2: Other participating organisations

Investment institutions	
APG Asset Management	Morgan Stanley Investment Management
Candriam	PIMCO
Capital Four	PineBridge Investments
East Coast Asset Management	Saturna Capital
HSBC Global Asset Management	SCOR SE
Janus Henderson	SKY Harbor Capital Management
Legal & General IM America	
CRAs	
DBRS Morningstar	Moody's Investors Service
Fitch Ratings	

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