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

BANKING SECTOR WORKSHOP - UK

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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 integrate environmental, social and governance (ESG) factors into credit risk analysis. This article summarises the key points from a workshop held with banks in the United Kingdom (UK), bringing together their representatives, investors and credit rating agencies. This workshop is the thirteenth of the series Bringing credit analysts and issuers together, as part of the ESG in credit risk and ratings initiative, which promotes a transparent and systematic consideration of ESG factors in credit risk assessment.[1]

The 27 January 2022 workshop attracted over 30 market participants, including seven representatives from four UK banks (see Figure 1 below), five representatives from five credit rating agencies (CRAs), and 15 investors from 14 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 UK banks

Companies	
Barclays	Nationwide
HSBC	Standard Chartered

The workshop with UK banks followed an earlier event with financial institution representatives from the European Union (EU). Another workshop was also organised afterwards with North American banks.[3] UK banks have different funding structures and costs compared to EU banks and face fiercer domestic competition. Moreover, even before Brexit, the UK was not part of the European banking union, implying that it has historically been subject to different regulatory requirements.

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

- promoting consensus around credit-relevant ESG issues in the UK 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.

[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 North American banking sector workshop summaries.

Several observations were common to those in previous workshops, therefore we encourage readers to familiarise themselves with other articles in the series, as 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: rapid adaptation to a changing environment
2. Climate change: the challenges of net-zero commitments
3. Social pillar: factoring in a just transition

1. GOVERNANCE: RAPID ADAPTATION TO A CHANGING ENVIRONMENT

ESG issues are becoming increasingly financially material to UK banks, with governance being the pillar most reflected in credit risk assessments. Aside from considering the traditional aspects of board oversight and management structure, CRA representatives and investors are also increasingly looking at how ESG issues affect a bank's risk profile. They are particularly interested in knowing how banks are mitigating risks and capturing opportunities in their financial strategies, risk management processes and governance structure.

According to workshop participants, this shift in perspective is due to the fast changing and complex environment in which banks are operating. Financial institutions are facing growing scrutiny from different stakeholders, especially on the regulatory front, in areas such as climate change, cybersecurity and data privacy. As a result, the likelihood of potential risks, such as reputational or litigation risks, is increasing.

To deal with the evolving nature of litigation risks, credit analysts and investors are looking beyond legacy issues and focusing more on prevention and remediation strategies. More specifically, in relation to prevention, it is important for investors to look at banks' litigation commitments, identification policies and due diligence performance. And when assessing the success of remediation strategies, investors analyse how previous controversies were handled. Finally, when it comes to restoring trust, being able to respond quickly to litigation seems to be the most important factor for all participants.

> "Banks are inherently exposed to litigation in a number of areas, so the risk will always be there. It's all about how banks respond to it." – CRA

In relation to potential future litigation risks arising from banks' insufficient climate action, one investor noted that the lack of standards in this area makes it difficult to know whether banks will be able to comply with their net-zero commitments and incoming sustainability-related regulations.

When asked about how governance is incorporated into their analysis, CRAs and investors mention a variety of strategies and tools. Many have implemented in-house processes, identifying financially material governance risks and incorporating them in the assessments, while smaller investment firms are using ESG scores directly from ESG information providers.

“There has been a shift from considering ESG factors to incorporating them in risk management and assessing how they are affecting issuers’ strategy and activities.” – Investor

As cyberattacks have become more common, cybersecurity risk is becoming increasingly important for both issuers and credit analysts. As a result, UK banks are investing in building resilience by conducting external penetration tests and implementing business recovery plans (in cases where risk materialises). Investors and CRAs, on the other hand, are struggling to assess the financial materiality of banks’ cybersecurity risks, given that financial institutions are hesitant to disclose information that could increase their vulnerability and exposure to cyberattacks.[4]

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- According to one investor, financed emissions should become the most important metric for assessing banks’ climate transition strategies.
- One bank mentioned using the GHG Accounting & Reporting Standard, an industry standard developed by the Partnership for Carbon Accounting Financials (PCAF), to prepare a corporate-level GHG emission inventory.

2. CLIMATE CHANGE: THE CHALLENGES OF NET-ZERO COMMITMENTS

Following the UN Climate Change Conference, COP26, UK banks have formalised net-zero commitments, with science-based targets for 2030 and 2050. To achieve these goals, banks are developing carbon neutrality plans that are reflected in their strategy, risk management policies, product origination, governance structure and responsibilities, and reporting.

One common challenge encountered by all financial institutions throughout this process is the difficulty in calculating Scope 3 carbon emissions, given that banks are dependent on clients’ ability to calculate and disclose their own carbon emissions. Issuers agree that this information is easier to obtain from large and global clients, but it is a much harder task when it comes to small and medium enterprises. Depending on the complexity and nature of the business model, banks are using different approaches to calculate Scope 3 emissions. Two bank participants with high portfolio diversification are prioritising the calculation of Scope 3 emissions by sector, initially focusing on oil and gas companies. To address the patchy nature of the information available via Energy Performance

[4] More information about this topic can be found in the EU banking sector workshop summary.

Certificates (EPC) from mortgage lending, one bank with low portfolio diversification has developed a model that takes all EPC data available and uses artificial intelligence to get estimates on remaining carbon emissions data.

On the regulatory question, the plurality of frameworks in different countries creates complexity when quantifying physical and transition risk exposure and other climate-related impacts. One bank with a strong international presence addresses these issues through a physical-risk assessment tool that considers various locations. ESG questionnaires are also personalised to clients' diverse profiles.

When asked if climate change is already affecting client selection and management, issuers admit that this work is not very advanced and that they are researching the potential impacts of such measures (i.e. banning clients because of their negative impact on the environment). Specifically, for one issuer with a significant presence in emerging markets, ceasing lending completely is not a viable solution as this would compromise the principle of a just transition.

"We must help companies go green. Divesting is not a solution. This is especially crucial to assure a just transition in emerging markets." – Corporate borrower

Overall, workshop participants acknowledged that environmental reporting regulation, such as the Task Force on Climate-related Financial Disclosures (TCFD) initiative (which became mandatory in the UK in 2022 for a range of entities), will be useful in driving data consistency and comparability over time. Despite their limitations, issuers see climate stress tests as a useful exploratory exercise that can help prioritise decarbonisation actions.

However, investors and CRAs have concerns about data reliability, particularly in climate-related scenario analysis with timeframes ranging from 5 to 30 years. Given a horizon of 12-18 months for credit ratings and the data quality issues raised, CRAs are complementing their evaluation of climate transition plans, from a credit risk perspective, through a qualitative assessment based on discussions with banks about their commitments, priorities and plans of action. They do admit, however, that this may change over time as data availability and quality improve, allowing for more robust comparisons.

"[In relation to the transition to a low carbon economy] We are more focused on talking to the banks on how they are approaching this, from the board level down to embedding it in credit risk assessments, risk appetite, and so on. We are not trying to compare and contrast, at this point." – CRA

Some investors, despite sharing similar concerns, are requesting more detailed information. According to one investor, it is critical that banks demonstrate a clear transition pathway with targets, using a sector-by-sector approach, and regularly report on progress. One reason for this is that investors' clients are demanding more quantifiable and comparable climate-related data. Investors are prioritising issuers who publish this type of data, even though the data is not yet comparable. According to one investor, it is critical to get started with the data that is available.

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- To overcome the lack of EPC data from mortgage lenders needed to calculate Scope 3 emissions, one bank is developing an estimation model using artificial intelligence.
- One issuer has been running in-house climate stress tests since 2019 to get a better understanding of climate-related risks.

3. SOCIAL PILLAR: FACTORING IN A JUST TRANSITION

When discussing the potential effects of a fast-paced energy transition, bank representatives highlighted the potential conflict between the climate shift and societal goals. To illustrate, one issuer shared the example of financing the construction of a port, an investment decision that generates a variety of environmental and social risks, opportunities and outcomes: biodiversity loss, pollution and increase in carbon emissions on the environmental side vs. job creation, new businesses and increased consumer choice on the social side. Bank representatives also said the transition to a greener economy could compromise the principle of financial inclusion, given that individuals and businesses with the fewest resources will have the most difficulty making the transition.

New financing structures, such as social bonds or loans, were suggested by one investor as a solution to allow issuers to fund projects with specific social benefits and investors to align their portfolios with social impacts. Nevertheless, these products pose some challenges for both issuers and credit analysts. One bank participant interested in using social bonds as a tool to finance a just transition expressed concerns about the lack of standards that can help define what a good societal outcome is. Moreover, third-party verification of these bonds is also crucial to avoid greenwashing. For banks, issuing green or social bonds because of a possible price advantage, but without a clear strategy on how they will effectively contribute to sustainable goals, could result in reputational damage. This can affect bonds' tradability, which may have a negative impact on the balance sheet.

"We have not issued any social bonds as we are still debating what the right assets [to fund] would be." – Corporate borrower

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Social bonds could become an increasingly important tool in supporting and promoting a just transition. However, it is important that these financial instruments have a clear use of proceeds or are linked to specific key performance indicators.

APPENDIX

Figure 2: Other participating organisations

Investment institutions	
Atlanticomnium	Neuberger Berman
AXA IM	Ninety One
Brown Advisory	Ostrum Asset Management
Conning Asset Management	PGIM Fixed Income
HSBC Global Asset Management	QIC
Janus Henderson	Saturna Capital
Morgan Stanley Investment Management	Wellington Management
CRAs	
Fitch Ratings	S&P Global Ratings
Kroll Bond Rating Agency (KBRA)	Scope Ratings
Moody's Investors Service	

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