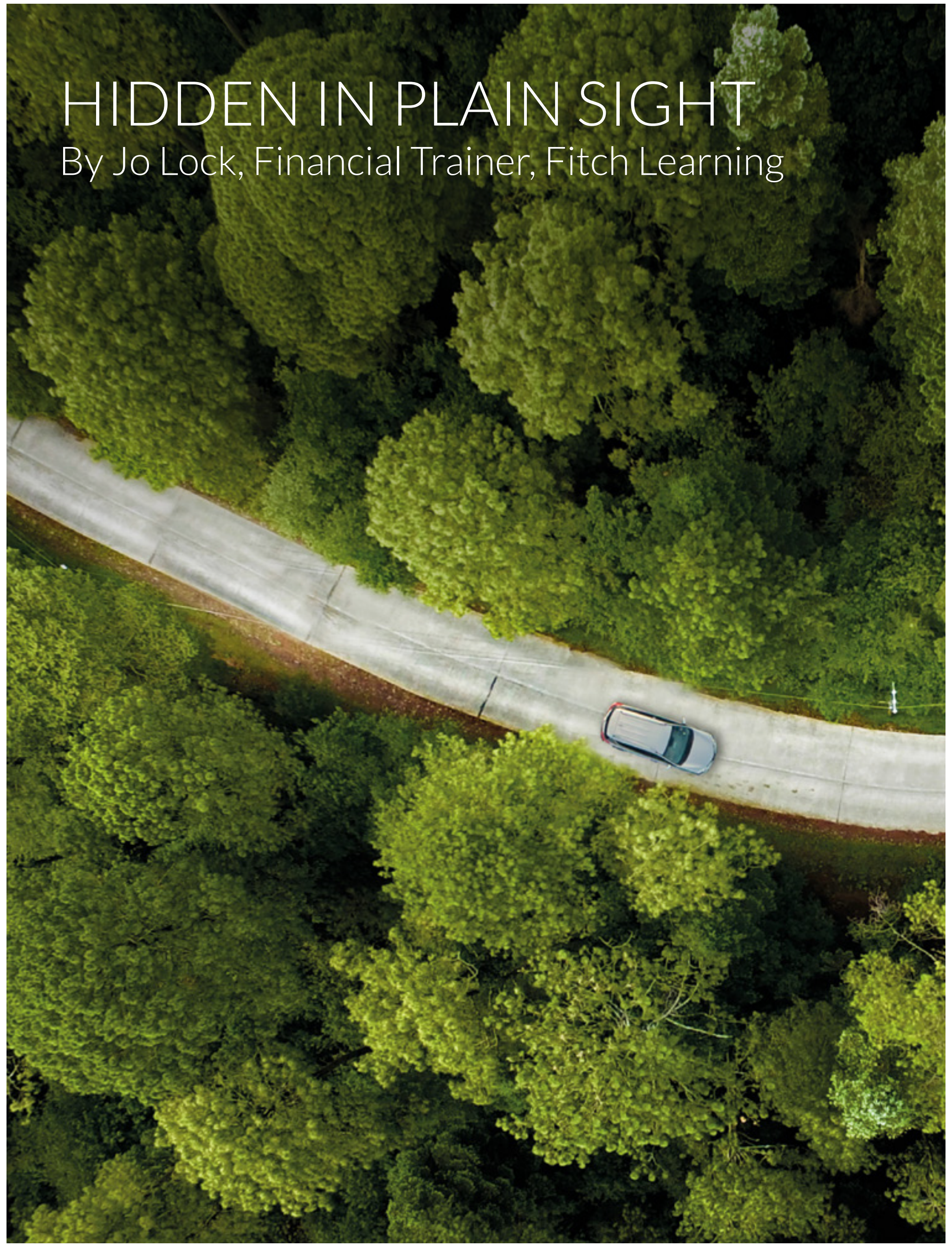
THE INTERSECTION OF ESG AND CREDIT RISK



Environmental, social and governance (ESG) factors have become a hot topic in financial circles in recent years, with the main focus up until recently being on investing into these themes to achieve superior returns, enhance investment diversity or build a more values-based portfolio.

Only lately have we begun to learn about how these ESG factors can be built into the credit decisioning process with the aim of identifying credit opportunities that are better quality in terms of lower risk or enable more sustainable future business prospects.

The good news is that many of the ESG considerations we talk about today have been themes of credit analysis for many years; we just haven't drawn specific attention to them.

ESG risks are drivers of traditional financial risks, so ESG in credit is not new, we are just learning how to change the lens through which we look at the same companies, borrowers, obligors, issuers or counterparties.

The European Banking Authority's ('EBA') June 2021 report on management and supervision of ESG risks for credit institutions and investment firms defines ESG factors as "environmental, social or governance matters that may have a positive or negative impact on the financial performance or solvency of an entity, sovereign or individual". It acknowledges that through different transmission channels these factors can become evident in the financial risk disciplines of not just credit risk, but also market, operational, liquidity and funding risks – see diagram below. The report even goes as far as to state that, "ESG risks can also impact the financial system and economy as a whole, with potential systemic consequences". This illustrates why ESG is so pertinent in the credit world today.

RISK DRIVERS			TRANSMISSION CHANNELS	FINANCIAL RISKS
ENVIRONMENTAL	**SOCIAL**	**GOVERNANCE**	Lower profitability	Credit risk
Physical • Acute • Chronic	Environmental risks	Inadequate management of E & S risks	Lower real estate value	Market risk
Transition • Policy changes • Technological changes • Behavioural changes	Changes in social policy	Non-compliance with corporate governance frameworks/codes	Lower household wealth	Operational risk
	Changes in market sentiment		Lower asset performance	Liquidity and funding risk
			Increased cost of compliance	Reputational risk
			Increased legal costs	

Figure 4 Summary of ESG risk drivers, their transmission channels and how these can impact financial risk categories

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ENVIRONMENTAL RISKS ARE MORE THAN JUST CLIMATIC

The one element of environmental risk that is front and centre is climate risk as pressure grows on governments and companies to achieve net-zero targets. In April 2021, the Basel Committee on Banking Supervision released a report on climate-related financial risks that looks in detail at the measurement of these risks and the practical implementation challenges for banks and supervisors.

The report acknowledges the need for forward-looking methodologies and quantitative data-based risk assessments, both of which are very much still in early-stage development. It concludes that whilst the economic and financial impacts of climate change may give rise to future losses for banking institutions (and, one could argue, for economies more broadly), "the frameworks for translating climate change scenarios into financial risks for banks remain relatively nascent". **The recent Fitch Learning article** by David Harper on Central Banks' Regulatory Response to Sustainability Issues explains how central banks are taking a more involved role in managing the regulation of the financial system as a policy lever to help achieve climate-related goals across the global economy. The question is whether the stick or the carrot will effect the necessary change.

From the credit viewpoint, additional non-climate-related environmental factors are still relevant yet do vary widely in their level of importance and corresponding risk. For some companies, the impact of environmental factors is relatively low, such as for financial institutions (though with the exception of property and casualty insurers directly exposed to environmental and natural catastrophe risks).

Whereas for corporates – particularly those engaged in manufacturing or commodity-related businesses - risks of emissions, energy use, hydrocarbon exposure and ecological risks are much higher. **Fitch Ratings' 2021 ESG in Credit White Paper** considers that of the three ESG factors, the lowest level of credit impact is currently attributed to environmental factors. This is believed to be mainly driven by a low level of cost crystallization from environmental legislation and regulation to date. Over time, such regulation is likely to grow and we should see more environmental costs being factored into credit profiles. An example is the UK government's new plastic packaging tax coming into force in April 2022 where producers and importers are liable for a tax of £200 per tonne for packaging with less than 30% recycled content.

SOCIAL FACTORS ARE MORE PREVALENT THAN WE THINK

The assessment of social factors' relevance to credit analysis is probably the most underdeveloped area at the current time and one where we still have much to learn. As social pressure on economic activities grows, the importance of social factors as a credit risk driver is likely to increase. In March 2021, we saw the ESG-related investor boycott of the Deliveroo IPO on grounds including rider safety, status and human rights (entitlement to the minimum wage). However, it is often quite difficult to identify which social factors are, or could become, relevant to a credit profile and to what extent. Changes in social policy or in market sentiment are key areas where credit impacts may be more obvious. Credit concerns may also stem from companies breaching their obligations in respect of employees, customers and suppliers, though these are difficult to quantify and the risk lies in the assessment of their materiality. That said, reputational damage is often highly unquantifiable, but can be significant when considering the impact on a business' franchise value, earnings, profitability and financial flexibility. We have seen this with the Volkswagen emissions scandal; first environmental, then governance and ultimately social factors all came to the fore in a case which culminated in the company's credit rating being downgraded by Fitch, Moody's and S&P in 2015, ground which it has yet to recover. The Covid-19 pandemic is an example of a social risk that has had far reaching and severe implications, triggering wide-ranging credit rating downgrades and negative outlooks. It has intensified social inequalities and crippled economies, yet such a scenario was almost inconceivable two years ago and did not feature in the financial stress tests run by regulators or by banks internally.

GOVERNANCE IS KEY

Good governance has always been of fundamental importance in the credit decisioning process. This may be at the sovereign level in terms of assessing a country's rule of law, political risk, control of corruption and regulation, or it may be at the company level when evaluating management competence and strategy, corporate financial reporting, internal governance and/or the quality of risk management and compliance. Per Fitch Ratings' research and subsequent discussion in their White Paper, "governance overall is the most dynamic ESG factor from a credit perspective", particularly for financial institutions and, to a slightly lesser extent, corporates, depending on their sector. Whilst good governance practices and well-managed governance risks would not necessarily enhance or uplift the credit profile of a company from the baseline, poor governance would certainly detract from it and could severely impact aspects of a company's risk profile over the short, medium and even long-term horizon. It is therefore of critical importance for companies to take a strategic view of governance factors and risks and incorporate these widely into their long-term planning.

Source: **www.thelancet.com**

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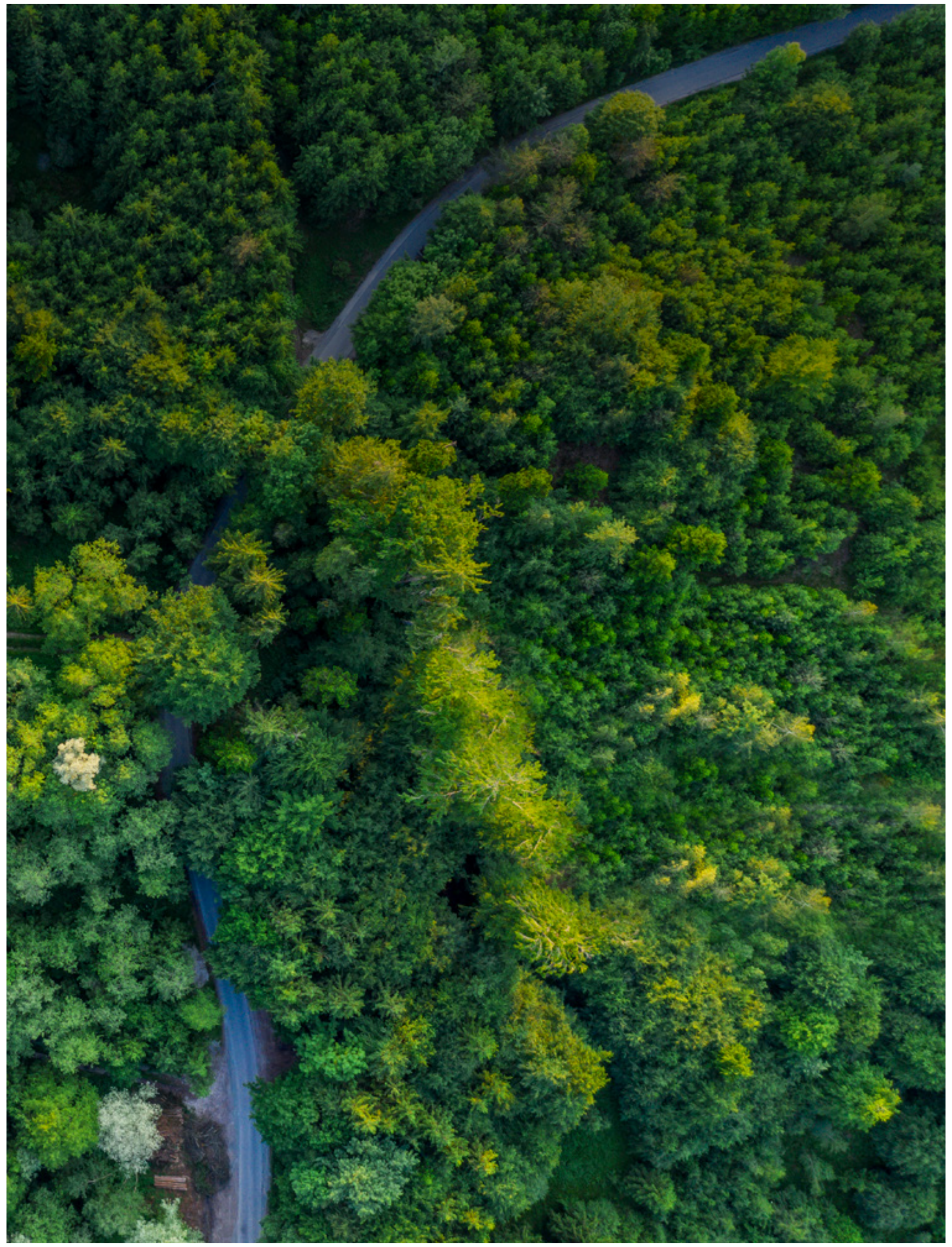

ESG AND CREDIT ARE ALREADY CLOSELY INTERTWINED

In essence, ESG factors can influence almost every factor and metric in both the qualitative and quantitative areas of credit analysis. They can also impact expected loss via the core credit parameters of probability of default (by reducing business viability), exposure at default (by causing drawdowns on committed credit lines due to physical risk events such as floods) and even loss given default (by lowering collateral values).

Furthermore, when ESG factors are incorporated as drivers into the credit ratings process, any downgrades may have an impact on lenders' capital requirements, thus increasing financial risks. Failure to address ESG issues could lead to poor reputation, misconduct risks, pricing errors and business development challenges, inter alia. Additionally, lower investor confidence and market confidence could result in liquidity issues, higher funding costs, challenges accessing bank facilities and ultimately, support. All in all, we are learning that credit entities that are adept at managing the ESG risks in their business should theoretically have a better and more sustainable credit profile.

SO WHERE NEXT?

The confluence of ESG and credit risk is currently a key focus at Fitch Learning and we are seeing more and more clients looking to us to provide expertise and help develop awareness in this area. In moving forward with the credit assessment of ESG risks, we need to identify, then evaluate and then incorporate these factors into action. At the highest level, these risks should form part of the risk appetite statement and be embedded within a company's risk management framework. They could emerge across multiple risk disciplines, not just credit. At the more granular level of credit analysis, one of the main challenges to building ESG into the creditworthiness assessment is the lack of available and comparative data and disclosures. This problem becomes even more acute when trying to undertake peer analysis. The good news is that this is changing, albeit slowly. However, for the time being we are having to deal with imperfect information and make many assumptions to form a credit view. What we have learned though, is that ESG factors' convergence with credit is too risky to ignore.

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