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 ESG.RS of '4' or '5' can be positive or negative to a rating decision, although most assigned scores reflect a negative impact. This report includes examples of how ESG issues are affecting the credit ratings of some Fitch-rated banks.

Governance Issues Remain Dominant: At end-1Q21, Fitch had assigned ESG.RS to 940 rated banks globally (the figure excludes supranational banks). 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 relevant to all bank ratings, albeit with a low impact. However, 16% of rated banks at end-1Q21 had been assigned 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.

As indicated in a recent report, we expect governance weaknesses to weigh on ratings more often than previously as the tolerance of governance failures from a range of stakeholders declines. This is also likely to be the case for banks.

Low Social and Environmental Credit Impact: The impact of social issues on bank credit ratings is still very low – about 3% of global bank ratings are affected by social considerations. This is also the case for environmental issues (about 1%). We highlighted in a report that social impacts would increasingly become more relevant to banks' credit profiles in the wake of mounting social inequalities linked to the protracted Covid-19 pandemic. While social impact on bank credit ratings is still low, we note some positive impacts feeding through to ratings and include some examples in this report.

We expect greater clarity around emerging environmental risks. This may result in analysts assigning more elevated environmental scores as disclosure around environmental issues increases and becomes more standardised and as regulators begin to consider the introduction of mandatory ratios to highlight the 'greenness' of banks' exposures.

Exposures to higher carbon-intensive industry sectors is not yet incorporated into prudential capital regimes for banks being used to enforce greater capital charges for banks, but we may see more elevated environmental scores should this change and analysts assess that capital adequacy headroom may become strained.

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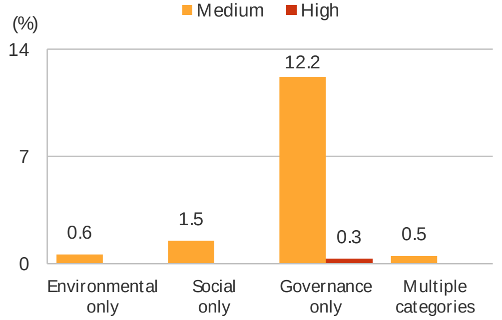
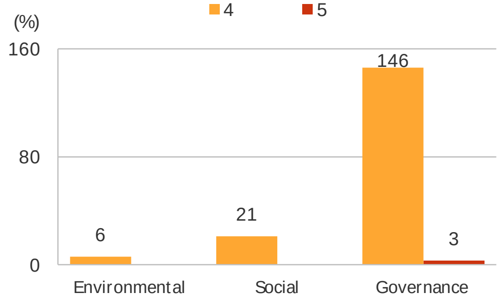
ESG Relevance to Issuer Portfolio, By Category



[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

Examples of Governance Impact on Credit Ratings

Credit Suisse Group AG (A-/Negative)

In April 2021, Fitch assigned a Negative Outlook to Credit Suisse Group AG's Long-Term Issuer Default Rating (IDR) and the group's ESG.RS for 'Governance Structure' was changed to '4' from '3', capturing aspects of the bank's controls, risk appetite, execution and earnings. The group's ratings are at risk from the repercussion of well-publicised losses in respect of positions linked to a large prime brokerage loss. Further longer-term financial, reputational and regulatory risks could arise from fallout from supply-chain finance provided to the failed Greensill Capital.

Credit Suisse's IDR could be downgraded if capital ratios are eroded and ambitious profit targets come under pressure in light of the above events. Significant disruptions to management and strategy could also contribute to ratings pressure.

Citigroup Inc. (A/Stable)

In May 2021, Fitch changed Citigroup Inc.'s ESG.RS for 'Governance Structure' to '4' from '3' to reflect gaps in its enterprise risk-management framework, as identified by the Federal Reserve and other regulators. In 2020, US regulators issued consent orders to Citigroup Inc. and Citibank N.A., including a USD400 million penalty, citing shortcomings in operations risk management, data quality and internal controls. Weakness in operations risk management was demonstrated by an erroneous payment of USD894 million to creditors of Revlon in August 2020.

Citigroup's ratings were affirmed in May 2021 but governance and oversight issues remain relevant to ratings, with lack of progress on the group's infrastructure transformation strategy and remediation of regulatory findings, stated as a negative rating sensitivities.

FBN Holdings Plc (B-/Negative)

In May 2021, Fitch changed FBN Holdings Plc's (FBNH) ESG.RS for 'Governance Structure' to '4' from '3' following the removal of non-executive directors on the boards of FBNH and First Bank of Nigeria (FBN), its main operating subsidiary and Nigeria's third-largest commercial bank, on 29 April by the regulator, the Central Bank of Nigeria (CBN). The CBN says it acted because FBN had made significant executive management changes, including replacing the chief executive, without its prior notice or approval. The CBN also highlighted corporate governance failings pertaining to long-standing and problematic related-party exposures, and failure to comply with regulatory directives.

Fitch believes the governance shortcomings cited by the CBN reflect poorly on FBNH's reputation and on the group's governance and control practices. Ratings for FBNH and FBN were affirmed, but uncertainty remains as governance shortcomings could damage FBNH's reputation and reduce investor confidence. Any additional remedial actions from the CBN could damage FBNH financially, especially if regulatory investigations highlight the need for certain loans to be classified as impaired or if loan loss provisioning needs to be strengthened. This could have a negative impact on capital adequacy.

Caixa Economica Federal (BB-/Negative)

In June 2021, Fitch reassessed Caixa Economica Federal's ESG.RS for 'Governance Structure' to '4' from '3'. Caixa, Brazil's third-largest bank by assets, performs a policy role in implementing government policies in the retail mortgage and domestic savings markets. Caixa is wholly owned by the federal government and Fitch believes that an increase of government influence on Caixa's management and strategy could negatively affect creditors' rights given the government's proven ability to influence the policies of the banks it controls. Caixa's ratings were affirmed but analysts observed that governance structure has a moderately negative 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	Management & Strategy
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.	Management & Strategy
Group Structure	Organisational structure, appropriateness relative to business model, opacity, intra-group dynamics and ownership.	Company Profile
Financial Transparency	Quality and timing of financial reporting, and auditing process.	Management & Strategy

Source: Fitch Ratings

Examples of Social Impact on Credit Ratings

The ratings of banks are rarely affected by social issues. **Capital One Financial Corporation** (A-/Stable), a US bank specialising in credit card finance, which experienced a data security breach in 2019, is a rare case. At the time, its ESG.RS for 'Fair Messaging, Privacy & Data Security' was raised to '4' from the standard score of '3' to reflect potential related damage to its franchise, but this was revised to '3' in May 2021 as analysts concluded that no noticeable franchise damage had occurred.

More recently, there a growing number of cases where analysts have identified 'Human Rights, Community Relations, Access & Affordability' as an issue that positively influences credit ratings. Positive impacts arising from various social lending policies adopted by several banks support their franchises, which feeds through to the ratings.

Freddie Mac and Fannie May (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 entities 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), **Agribank, FCB, AgFirst Farm Credit Bank, CoBank ACB** and **Farm Credit Bank of Texas** (all 'AA-'/Stable) to reflect the extent to which farm lending in the US, which Fitch analysts view as a key social service, is supported by these entities and for which they receive parental support. The support provided directly and positively impacts the issuers' credit profile.

Fondo Mivivienda, S.A. (BBB+/Negative) in Peru is a similar case to the US GSEs and also has a 4[+] ESG.RS 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 (BB-/Stable)

In May 2021, Fitch revised Banco de Desarrollo Rural, S.A.'s (Banrural) ESG.RS for 'Human Rights, Community Relations, Access & Affordability' to '4[+]' from '3' to reflect a moderately positive impact on the bank's franchise from its focus on providing services for underbanked communities in Guatemala. Banrural's lending is heavily weighted towards the retail sector, SMEs and microfinance sectors, which represented about 68% of total end-2020 loans, and the bank holds leading positions in microfinance lending (69% share at end-March 2021), SME finance (38%) and consumer credit (26%). Banrural's ratings were affirmed but analysts consider that its focus on community finance is a strong differentiating factor that supports its franchise.

Caixa Economica Federal (BB-/Negative)

In June 2021, Fitch changed Caixa's ESG.RS for 'Community Relations, Social Access, Affordability', to '4[+]' from '2'. Caixa's 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, where it has a 68% share. Amid the challenging economic scenario caused by the coronavirus in Brazil, Caixa reinforced its policy role by implementing various social measures to mitigate the downside effects of the pandemic. The bank was responsible for operating the largest social transfer programmes in Brazil's history, which totalled BRL384.8 billion (about USD80 billion) and reached more than 121 million people. These factors considerably boost Caixa's franchise, strengthen its credit profile and have a moderately positive impact on its ratings.

ESG Relevance Scores – Social Issues Assessed

Social (S)

General issues	Sector-specific issues	Reference
Human Rights, Community Relations, Access & Affordability	Services for underbanked and underserved communities: SME and community development programmes; financial literacy programmes.	Company Profile; Management & Strategy; Risk Appetite
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 Appetite; Asset Quality
Labour Relations & Practices	Impact of labour negotiations, including board/employee compensation and composition.	Company Profile, Management & Strategy, 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.	Company Profile, Earnings & Profitability

Source: Fitch Ratings

Examples of Environmental Impact on Credit Ratings

Fitch-rated banks are only very rarely affected by environmental issues. The main reason is that banks' relatively 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. Transitional risks from climate change, on the other hand, are expected to materialise over the long term, potentially stretching out over 30 to 50 years, which 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 with **Puerto Rican** banks, scored '3' for this factor, against a standard score of '2' for banks globally, because the impact of Hurricanes Irma and Maria, while having complicated the Commonwealth of Puerto Rico's efforts to reverse outward migration, generate sustainable economic growth and address its fiscal and debt imbalances, has not had a sustained negative impact on bank's credit profile. **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 Appetite
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.	Company Profile, Asset Quality

Source: Fitch Ratings