Financial Institutions: KBRA's Approach to ESG Climate and Reputational Risk Management

This Kroll Bond Rating Agency (KBRA) report is a follow-up to a recent research publication on how environmental, social, and governance (ESG) factors are considered in KBRA's credit rating process across corporate, financial, and government (CFG) ratings. While our previous publication provided a broad overview of ESG at KBRA, this research report focuses on ESG topics and their potential influence on KBRA's analysis of financial institutions. Given the evolving nature of ESG credit risk analysis, this research should not be taken as methodology. KBRA's proposed cross-sector ESG methodology can be found here.

As discussed in our Credit Ratings Deserve ESG Risk Analysis, Not ESG Scores report, KBRA embraces numerous ESG initiatives including efforts to improve the quality and frequency of issuers' disclosures. KBRA also reiterates our belief that the role of analysts at a credit rating agency is to remain focused on ESG factors that are material to credit, and we believe the best way to analyze the relevance of ESG factors in credit ratings is through fundamental credit risk analysis. As we have explored these various topics as they relate to credit risk analyses of financial institutions, we have developed a framework for identifying the most relevant ESG factors as they pertain to our rated universe, while also striving to identify and understand ESG factors unique to each rating and issuer. In practice, KBRA's ESG Management framework (under the scope of our risk management analysis) examines the various aspects of ESG and their impact on the financial institutions that we rate globally and industrywide, to deepen the understanding of these evolving topics. Through this lens, we incorporate pertinent ESG factors into our credit analysis. In addition to the idiosyncratic ESG risks related to each specific debt issue or issuer, the ESG Management analysis of financial institutions increasingly includes a review of broadly relevant topics such as climate and stakeholder risk considerations, and how these factors impact operations and influence corporate strategy and financial planning. We also examine how certain considerations affect a company's market position, reputation, and customer base as well as other key stakeholders. Importantly, KBRA recognizes the increasingly important role of ESG and growing focus of regulators on these topics as it becomes ever more apparent that ESG factors—both direct and indirect—present significant risks and opportunities for financial institutions.

Through our research, and further informed by our ongoing conversations with the management teams of various financial institutions, we have developed sample questions to address the key ESG topics that we believe are often the most relevant to our rated universe and useful to investors. These inquiries also allow for the identification of unique ESG credentials that differentiate financial institutions from one another, including in the global forum. We summarize key findings from our discussions with management, company reports, and presentations in a table, which are typically included in the Appendix section of our bank reports (an Appendix is included at the end of this report for illustration). The table aims to capture the most useful information for investors as well as highlight key factors under the scope of our risk management analysis.

Key Takeaways

- KBRA believes that credit-relevant ESG risks and opportunities are unique to every rating and issuer. Our approach to evaluating the management of ESG issues is a bespoke and dynamic process.
- KBRA does not deploy subjective value-based ESG scoring rubrics.
- KBRA believes ESG factors that impact credit risk need better disclosure and are best examined through the lens of risk management analysis for financial institutions. Under our ESG Management framework, we seek to understand the ways that a financial institution's management team can identify, address, and mitigate relevant ESG risks (or capitalize on opportunities), and/or the ways a specific transaction structure can mitigate these risks.
- As we gather data on relevant ESG considerations for our rated universe, we believe the most effective way to communicate our findings is in our rating and surveillance reports.
- Our approach is centered on examining material ESG factors and their impact on an institution's credit profile while highlighting opportunities and investigating exposures, as well as offering deeper disclosure of an issuer's plans or a transaction's features that take these factors into account.
- Consistent with how we assess default and recovery risk, we view the management of ESG factors as a dynamic process along a continuum, rather than a point-in-time judgment.
- In addition to the unique ESG risks related to each specific debt issue or issuer, KBRA's ESG Management analysis increasingly includes a review of broadly relevant topics such as climate risk, stakeholder preferences, and reputation risk.

ESG Scores Are Not Part of KBRA Credit Analysis

As we gather data on relevant ESG considerations for our rated universe, we believe the most effective way to communicate our findings is in our rating and surveillance reports. KBRA's ratings incorporate all material credit factors including those that relate to ESG factors. While ESG factors may influence ratings, it is important to underscore that KBRA's ratings do not incorporate value-based subjective judgments as this is inconsistent with objective credit analysis. Throughout our analysis, KBRA captures the impact of ESG factors in the same manner as all other credit-relevant factors. Our approach is centered on examining material ESG factors and their impact on an institution's credit profile while highlighting opportunities and investigating exposures, as well as offering deeper disclosure of an issuer's plans or a transaction's features that take these factors into account.

As an alternative to ESG scores, KBRA will often use a two-step process to identify and integrate credit-relevant ESG considerations into our credit ratings analysis. First, we identify ESG factors with a direct impact on a given issuer or transaction. KBRA defines direct impact as those factors that have a clear, tangible effect on credit, are typically quantifiable, and the assessment of which is generally rooted in existing methodologies. In the second step, we seek to understand and encourage disclosure of a broader array of ESG-related risks or opportunities that may have more indirect or more future-oriented credit impact.

In either case, KBRA performs its ESG factors analysis through the lens of risk management analysis, which includes assessment of an issuer's ability to identify, plan for, and mitigate risks or to amplify opportunities.

KBRA's ESG Management Analysis Framework for Financial Institutions

For financial institutions, the assessment of many ESG factors is captured in our general review of risk management. Our direct dialogue with management teams enhances our understanding of ESG risk exposure while also improving the quality and consistency of disclosure. Under the risk management determinant, KBRA evaluates the overall effectiveness of a financial institution's risk management framework to determine whether it adequately captures and addresses the plausible risks to which the entity is exposed. KBRA generally considers the roles and responsibilities of individuals involved in the various risk management functions and the scope of risks to be managed. When relevant, we may analyze management teams' awareness of existing, emerging, and potential risks, and the processes in place for identifying, assessing, and responding to relevant risk factors, including ESG considerations, as well as how these functions compare to peers. Key areas of focus may include risk oversight, risk infrastructure, quality of management information systems, risk appetite framework, and governance risk. KBRA may also review the organization's overall risk appetite and culture, the risks stemming from the complexity of the institution, and any related party risks. We believe that an issuer's risk management framework should be comprehensive, yet also dynamic and flexible enough to accommodate evolving factors, including ESG considerations.

Direct Impact

KBRA's rating analysis incorporates material credit factors, including those that relate to ESG factors. Throughout our analysis, KBRA captures the impact of ESG factors in the same manner as all other credit-relevant factors, which is reflected in relevant sections of our published reports. Examples of direct and impactful ESG factors can include:

- A financial institution with relatively aggressive risk taking and overall risk management and/or product pricing not appropriately in line with risk levels.
- A financial institution with considerably higher than average exposure to the oil and gas industry, which could impact capital costs and ability to attract institutional customers over time.
- Incidences of and exposure to cyber risks that exceed industry peers and are not improving to a level in line with regulatory expectations.
- Financial performance or planning that is significantly impacted by higher risk of climate-related issues, including tornadoes, flooding, earthquakes, etc.

Alternatively, KBRA also recognizes that certain ESG factors may positively impact credit for some debt issues or issuers, such as:

- Comparatively conservative risk management with strong controls and ability to price products prudently in line with risk levels.
- A competitive advantage due to a business model that focuses on the economic development needs in a given community.
- An investment strategy centered on assets directly tied to financing renewable energy improvements.
- Comprehensive and detailed mitigation of operational/technological risks.

Indirect Impact

KBRA believes that the relative ability of issuers to identify, disclose, and address a broader array of ESG factors which may be less direct or immediate is an increasingly important credit consideration. Such insights into ESG Management include:

Awareness:

- Does the management team exhibit awareness of existing/emerging/potential climate, operational/technological, and stakeholder preference/reputational factors that could impact strategies, financial performance and planning?

Planning:

- Has the management team adequately assessed the potential impact of these considerations, including through financial planning and stress testing, if applicable?

Ability to execute:

- What potential impact could these factors have, and would it materially affect operations and planning?

Common ESG Factors

KBRA has identified a subset of ESG factors that are most commonly credit-relevant for financial institutions. These factors increasingly include climate risk and stakeholder preference and reputational risk. KBRA's approach to these increasingly relevant factors is described below.

Climate Risk

When analyzing climate risk for financial institutions, we often evaluate the level of oversight of climate-related issues, including both physical risks, such as extreme weather, and transition risks, which are indirect and relate to an entity's ability to respond to regulatory pressure to decarbonize either its own operations or that of its portfolio. KBRA analysts may request information on how management teams evaluate climate-related regulatory or stakeholder risk exposure and incorporate that exposure into their risk management processes. We may analyze the processes in place for identifying, assessing, and responding to relevant risks and opportunities as a firm and compared to peers.

KBRA believes that financial institutions that adequately identify and quantify their climate-related risks will be better positioned to manage their exposure and mitigate these risks over the longer term. Broadly speaking, financial institutions that are not analyzing and mitigating their climate exposure are more likely to experience knock-on credit effects, which may stem from increased pressure from stakeholders or increased costs due to regulatory changes.

Climate change is also increasingly a topic of interest for the various stakeholder groups that financial institutions are accountable to, including customers, regulators, employees, and others. How stakeholder preferences can influence credit ratings is described in more detail below, but note that many stakeholders are increasingly focusing attention on financial institutions' lending to high-polluting industries. We often ask financial institutions to describe their outstanding loan portfolio to understand the entity's risk exposure to carbon-intensive sectors.

Typical questions on the topic of climate risk exposure may include:

- Discuss board oversight of climate-related issues as well as processes for identifying, assessing, and responding to risks and opportunities.
- Describe where and how climate-related risks and opportunities may have influenced your organization's strategy and/or financial planning.
- Does your organization have an established process for identifying, assessing, and responding to climate-related risks and opportunities?
    - If No: Why does your organization not have a process in place for identifying, assessing, and responding to climate-related risks and opportunities, and do you plan to introduce such a process in the future?
- Have you identified any inherent climate-related risks with the potential to have a substantive financial or strategic impact on your business?
    - If Yes: Provide details of risks identified with the potential to have a substantive financial or strategic impact on your business.
    - If No: Why do you not consider your organization to be exposed to climate-related risks with the potential to have a substantive financial or strategic impact on your business?
- Did your company calculate your CO_2 emissions this year?
    - If Yes: What were they?
    - If No: Please explain why not.

- Discuss aspects of the loan portfolio directed toward renewable energy projects or lending opportunities in the area of energy efficiency.
- Outline any facilities that are environmentally oriented, either LEED certified or enhanced.

Stakeholder Preference and Reputational Risk

KBRA recognizes that each issuer, regardless of industry or sector, may face pressures from their stakeholders' own ESG preferences. KBRA believes it is important for issuers to demonstrate awareness of and disclose the ESG preferences of their key stakeholders, and how these preferences may impact the issuer's operating, capital, and financial strategies. As KBRA analysts interact with management teams, one guiding question we often use to initiate inquiry into an issuer's management of stakeholder preferences and related reputational risks is: do your investors, customers, employees, regulators, or other key stakeholders have ESG goals or policy preferences that present risks and/or opportunities to your enterprise? This line of inquiry gives us insight into management's understanding of, and its strategy for, managing various stakeholder pressures.

For example, a financial institution's success is often guided by the strength of its relationship with its core customer base, its responsiveness to those customers' preferences, and its positive contribution to the surrounding community. We may ask financial institutions about their community development work, literacy programs, and/or loans to low-income borrowers, among other relevant topics. These questions help us understand a bank's reputation in the communities they operate in, which can often have both financial and credit implications. We also typically ask management teams about the number of data breaches the firm has faced, the policies and procedures around whistleblower complaints, and relevant litigation, which allow us to gauge an entity's exposure to reputational risk.

Key topics for discussion may include:

- Number and amount of loans outstanding, past due, and non-accruing associated with programs designed to promote small business and community development.
- Describe any bank deposit or lending products geared toward low-income customers as well as low-income housing, etc.
- Number of no-cost retail checking accounts provided to previously unbanked or underbanked customers.
- Number of participants in financial literacy initiatives for unbanked, underbanked, or underserved customers.
- Number and amount of loans outstanding, past due, and non-accruing extended to customers in least developed economies.
- Describe any bank deposit or lending products geared toward customers in least developed economies.
- Number of data breaches, percentage involving personally identifiable information (PII), and number of account holders affected.
- Description of whistleblower policies and procedures.
- Description of approach to identifying and addressing data security risks.
- Total amount of monetary losses as a result of legal proceedings associated with fraud, insider trading, anti-trust, anti-competitive behavior, market manipulation, malpractice, or other related financial industry laws or regulations.

Conclusion

ESG factors are complex and ever evolving. As we develop and advance our understanding of these complex topics, we aim to identify key considerations and unique opportunities/concerns. As we gather data on relevant ESG considerations for our rated universe, we believe the most effective way to communicate our findings is in our rating and surveillance reports. KBRA's ratings incorporate all material credit factors including those that relate to ESG factors. While ESG factors may influence ratings, it is important to underscore that KBRA's ratings do not incorporate value-based judgments. Throughout our analysis, KBRA captures the impact of ESG factors in the same manner as all other credit-relevant factors. In KBRA's view, there are relatively few ESG factors that materially impact the credit ratings of financial institutions; however, though not necessarily material now, the ESG factors uncovered during KBRA's due diligence process may become more relevant to credit over time.

Appendix

KBRA reports typically included analysis of ESG risks and strengths under the relevant sections (see links to examples below). In response to investor demand, we now summarize these views under the ESG Management section of our bank reports and typically include an ESG Table that lists additional ESG-related information.

Amalgamated Bank
Ameris Bancorp
Atlantic Union Bankshares Corporation
Signature Bank
Zions Bancorporation, National Association

ESG Additional Information	
Environmental-Related	**Description and Other Information**
Board oversight of climate-related issues and process for identifying, assessing and responding to risks/opportunities	
Influence of climate-related risks and opportunities on strategy/financial planning	
Process for identifying, assessing, and responding to climate-related risks and opportunities	
Any inherent climate-related risks with the potential to have a substantive financial or strategic impact on the business	
Calculation of CO_2 emissions in current year	
Aspects of loan portfolio directed to renewable energy projects or lending opportunities in the area of energy efficiency	
Portion of loan portfolio to energy and other carbon-intensive industries	
Any facilities that are environmentally oriented, either LEED certified or enhanced	
Social-Related	
Number and amount of loans outstanding, past due, and non-accruing associated with programs designed to promote small business and community development	
Any bank deposit or lending products geared toward low income customers as well as low-income housing, etc.	
Number of no-cost retail checking accounts provided to previously unbanked or underbanked customers	
Number of participants in financial literacy initiatives for unbanked, underbanked, or underserved customers	
Governance-Related	
Number of data breaches, percentage involving personally identifiable information (PII), and number of account holders affected	
Description of whistleblower policies and procedures	
Description of approach to identifying and addressing data security risks	
Total amount of monetary losses as a result of legal proceedings associated with fraud, insider trading, anti-trust, anti-competitive behavior, market manipulation, malpractice, or other related financial industry laws or regulations	

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