Nordic Credit Rating

SECTOR COMMENT

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ESG factors in financial institution ratings

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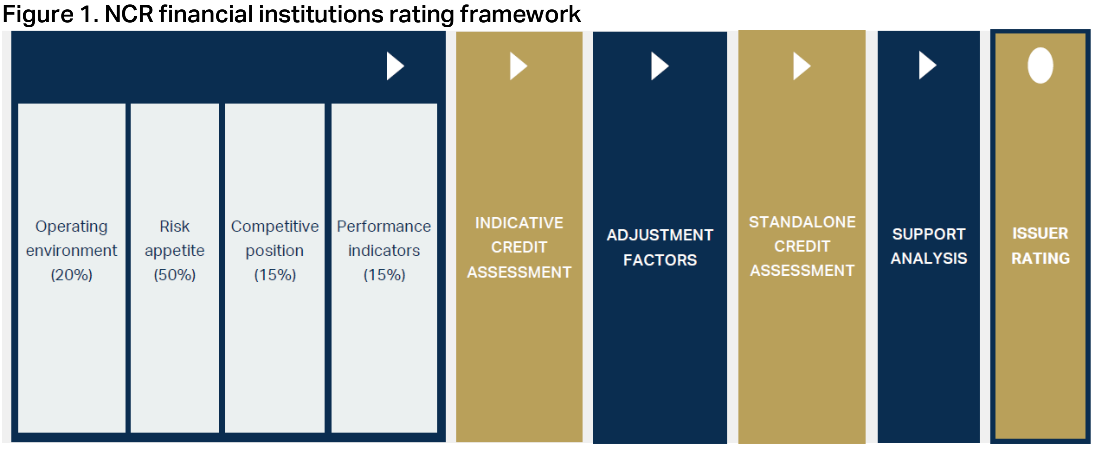
Nordic Credit Rating (NCR) is committed to increasing the transparency of how environmental, social and governance (ESG) factors impact the creditworthiness of financial institutions. We take account of ESG factors and highlight them in our credit rating reports where we believe they are material and relevant to the creditworthiness of an issuer. ESG factors can influence ratings, outlooks and headroom within ratings. The potential influence of ESG factors on our credit ratings depends on the financial impact they have on an entity's creditworthiness, whether positive or negative. We consider an entity's public disclosures on ESG factors and engage in dialogue with management regarding the exposure to and management of ESG-related risks in all facets of its business.

Our rating methodology for financial institutions includes the important factors that we deem relevant in assessing creditworthiness. It takes into account each issuer's exposure to its operating environment, risk appetite, competitive position and its historical and projected performance.

Figure 1. NCR financial institutions rating framework

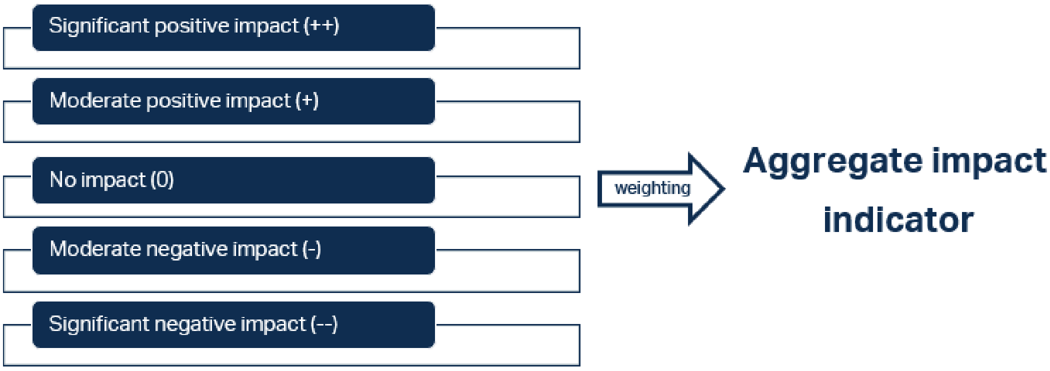


INCLUSION OF ESG FACTORS IN RATING REPORTS

A financial institution's exposure to ESG factors is taken into account in all components of our methodology, where relevant. The factors included in an assessment are those tangible issues with the potential to directly impact on the issuer's operating environment, risk appetite, competitive position and performance indicators. In addition, NCR has the ability to make adjustments based on peer comparisons, which could include ESG factors not adequately captured in other parts of the indicative credit assessment.

The ESG analysis in our rating reports reflects how key ESG risks are considered in the credit analysis of a financial institution. In addition, we highlight the aggregate impact of these risks on an issuer's credit rating. The five impact levels associated with each risk (see Figure 2) are neither equivalent to ESG ratings nor indicative of rating notches. Instead, they are indications of the relative positive or negative impact ESG risks have on our issuer rating and subfactors.

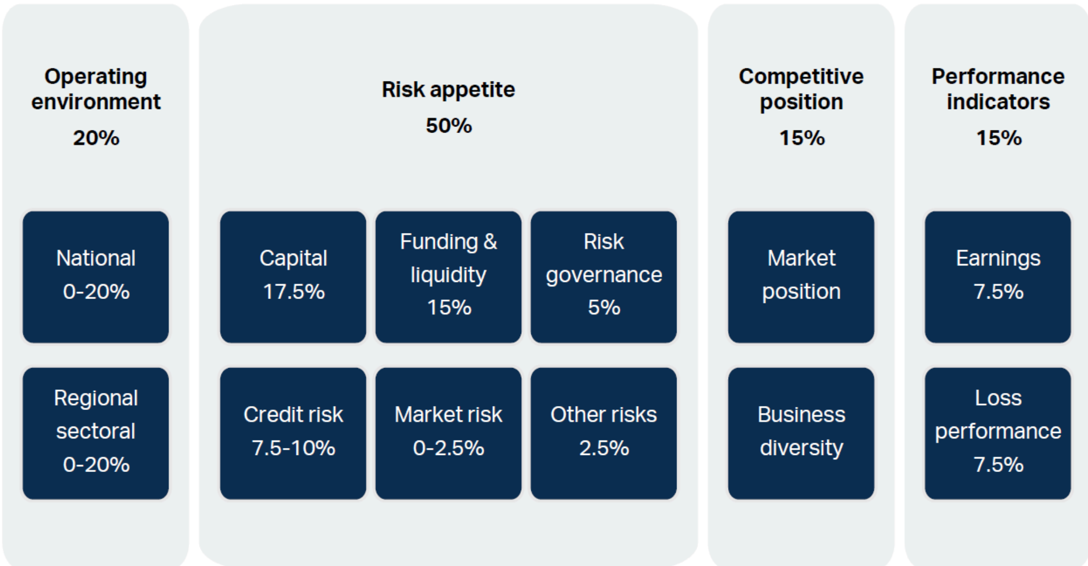
Figure 2. ESG factor impact levels for subfactor scoring and indicative credit assessment



OPERATING ENVIRONMENT

NCR considers the strength and stability of a country's institutions in its assessment of an issuer's operating environment, with national governance standards and transparency playing a significant role. In addition, we consider an institution's regional and macro-linked sectoral concentrations and/or cross-border risk levels where they materially differ from the national assessment. Such differences could reflect our view of the relative strength of other countries' governance and/or our view that specific regional or sectoral social or political risks could affect an institution's business model and earnings capacity.

Figure 3. Categories & subfactors for NCR's indicative credit assessment of financial institutions



RISK APPETITE: CAPITAL

Our assessment of a financial institution's capital is primarily concerned with the buffer in relation to regulatory requirements. ESG factors may have an impact on capital requirements, as well as internal capital guidelines.

RISK APPETITE: FUNDING & LIQUIDITY

Part of our funding and liquidity assessment concerns diversification of funding sources. As we perceive markets to be increasingly favourable towards green or sustainable bonds, the existence of such a framework could impact our assessment in borderline cases. In addition, a strong ESG profile could have a positive impact on our view of the price dependency of customer deposits.

RISK APPETITE: RISK GOVERNANCE

Our risk governance assessment considers the degree to which risk culture is embedded in a financial institution's decision-making, including risks related to ESG factors. In our view, risk governance and a well-defined risk appetite and risk monitoring can be key determinants of whether an institution is equipped to weather a macroeconomic or idiosyncratic downturn. An institution whose top-level management decisions and limit-setting drive decision-making, pricing and behaviour throughout the organisation is better positioned to avoid risk pitfalls and respond quickly to a deteriorating operating environment. Conversely, institutions that experience risk governance problems may face considerable public and regulatory scrutiny, which could affect performance, the business model and, ultimately, customer and investor sentiment.

RISK APPETITE: CREDIT RISK

Our risk appetite assessment allows for adjustments not fully captured by an institution's capital ratios in our assessment of credit risk. Although some issuers may be in the early stages of development, we expect all rated issuers to have incorporated ESG considerations into their respective credit policies, in proportion to their size and sectoral and/or regional exposures. Where an issuer has a high share of lending to sectors or regions with risks negatively associated with ESG factors, we could consider ESG concentrations to be a concern. For example, lending to companies with high levels of fossil fuel use, governance concerns, or significant exposure to climate-related risk, whether physical or transitional. In addition, we expect issuers with large mortgage or other real-estate exposures to ensure they are sufficiently aware of physical climate risks to collateral in the region(s) in which they operate.

RISK APPETITE: OTHER RISKS

'Other risk' is defined in our methodology as a variety of additional forms of risk that could adversely affect financial institutions. Some of these are closely linked to ESG factors. The typical risks not considered elsewhere in the analysis include operational, reputational, legal, cyber, strategic, money laundering, business and regulatory risk specific to the entity.

COMPETITIVE POSITION

Our view of a financial institution's competitive position focuses on an institution's pricing power and material influence over its local, regional or national markets that support its ability to perform in line with its risk appetite. Within this description, an institution's ability to maintain customer relationships, irrespective of its size and business diversity, plays a key role. As seen across the Nordic banking market, ESG factors, both in terms of managing risks and supporting brand loyalty, can have a direct impact on the ability to maintain and attract customers.

Where there is fierce competition in a market, we believe it is difficult for financial institutions to have an advantage in terms being able to drive pricing or attract stronger customers based on positive reputational factors. In fact, the opposite is often true. Where banks have faced public scrutiny, customers are more likely to turn to those lenders yet to come under the spotlight. Consequently, some less directly financial material ESG factors might be of importance to reputational risk.

PERFORMANCE INDICATORS

The performance indicators we use provide insight into recent and projected capital generation and loss performance. These indicators essentially help NCR to assess whether an institution's financial results support or contradict our qualitative view of its risk appetite. They are directly affected by ESG factors that can impact an issuer's growth, pricing and loss reserves.

ADJUSTMENT FACTORS

In addition to incorporating ESG factors into the areas of the initial credit assessment mentioned above, NCR may also identify any significant aspects not already considered and apply a positive or negative adjustment to the indicative credit assessment under our adjustment factors.

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