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INVESTORS SERVICE

REQUEST
FOR COMMENT

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General Principles for Assessing Environmental, Social and Governance Risks: Proposed Methodology Update — Financial Institutions Appendices

Summary

In this Request for Comment, we propose to update the *General Principles for Assessing Environmental, Social and Governance Risks Methodology* with the addition of two appendices that would provide more detailed information on the principal considerations for assigning Environmental (E), Social (S) and Governance (G) issuer profile scores (IPSs) and credit impact scores (CISs) to financial institutions.[1]

The key proposed revisions to the current methodology are as follows:

» **Provide more details on the credit implications for financial institutions of E, S and G considerations and how we assign IPSs and CISs.** Under our proposal, we would describe how we would apply the existing general methodological framework for determining E, S and G IPSs, as well as CISs, to financial institutions specifically. Our assessment of a financial institution's exposure to ESG risks and benefits would be primarily qualitative, and we would describe relevant considerations generally applicable across financial institution sectors. Our qualitative assessment may be informed by quantitative metrics, although these are indicative and often not available for all rated entities. Metrics also may vary among sub-sectors reflecting differences in relevance, reporting standards and disclosure levels. See proposed Appendix 1.

» **Provide more details on the qualitative considerations and illustrative types of quantitative metrics informing IPSs and CISs for financial institutions.** We would add a compendium describing the considerations and indicators generally relevant across financial institutions informing E, S and G category scores and IPSs. Over time, we may expand this compendium to provide further detail of more sector-specific considerations and the types of metrics we may use, which we may broaden or adjust as more data become available or indicators become more or less relevant to our analysis. See proposed Appendix 2.

We may also make some editorial changes to enhance readability.

Following publication of the updated methodology, we would enhance transparency in our communications of E, S and G considerations, which we already incorporate into our credit analysis, by assigning IPSs and CISs to financial institutions over time.

[1] The issuers we propose to cover under this framework are financial institutions, which are categorized under the private sector in our heat maps and include banks; finance companies; securities firms and market infrastructure providers; insurance firms (health insurers, life insurers, property and casualty insurers and reinsurers, insurance brokers and service companies, mortgage insurers, title and trade credit insurers, and financial guarantors); asset managers and pension funds; and multilateral development banks (MDBs).

Impact on Ratings

If this cross-sector methodology is updated as proposed, we expect no changes to outstanding ratings for financial institutions. In establishing E, S and G IPSs, we propose to use the general principles described in the existing methodology. The CIS is an output of the rating process that more transparently communicates our assessment of the impact of ESG considerations on assigned ratings in the context of other credit drivers. As such, our proposed publication of CISs will not change any ratings, currently or in the future.

This expected rating impact only reflects the methodological changes noted above and does not incorporate potential impact from other factors, including prevailing market conditions or factors specific to a particular issuer or transaction, such as financial metrics or qualitative considerations, that may be relevant to the rating analysis.

How to Submit Comments

In this Request for Comment, we are seeking feedback on our proposed addition of two appendices to the *General Principles for Assessing Environmental, Social and Governance Risks Methodology*. The proposed financial institutions appendices for the methodology follow. Prior to publication of the revised methodology, we may also consider other changes to the methodology as a result of the consultation process and our internal review.

We invite market participants to comment on the Request for Comment by August 11, 2021, no later than 11:59 p.m. US Eastern time, by submitting comments on the Request for Comment page at www.moodys.com. Upon appropriate consideration of received comments, we will adopt and publish a revised *General Principles for Assessing Environmental, Social and Governance Risks Methodology*.

Proposed Appendix 1

Issuer Profile Scores and Credit Impact Scores for Financial institutions

In this appendix, we describe how we apply the general framework for determining E, S and G IPSs and ESG CISs (described in Appendices A and B of the existing methodology, respectively) to financial institutions. The issuers covered under this framework are financial institutions such as banks, insurers, asset managers and other financial services providers. The framework also applies to multilateral development banks (MDBs). All of these sectors are categorized under the private sector in our ESG heat maps.

In establishing E, S and G issuer category scores and overall IPSs for financial institutions, we make a qualitative assessment of the issuer's exposure to the related risks or benefits. Our assessment of E, S and G focuses on credit-relevant considerations and the extent to which they are positive or negative for credit profiles. Issuer category scores reflect our assessment of the likelihood and magnitude of current and future credit exposures related to the category of ESG risk, including their effect on earnings, asset performance, capital, cash flow, business strategy and business profile.

These assessments are forward-looking and may be informed by a financial institution's previous experience of these risks. In some cases, our assessment may be informed by scenario analysis, for example for risks that are event-driven or are long term, such as carbon transition risk or physical climate risks. We incorporate a long-term perspective of risks into our assessments of issuer category scores and IPSs. We thus consider risks that have the potential to impact ratings over time even if these risks are expected to unfold far into the future providing a longer time frame for issuers to adapt.

The IPS and category scores also incorporate meaningful mitigating or strengthening actions related to those specific exposures. Risk mitigation on its own does not indicate an IPS or category score of 1. To score an IPS of 1 for any category or for the E, S or G IPS overall, a financial institution must derive a material credit benefit. For example, a financial institution may score S-1 if we assess that it will likely obtain a material and sustainable business advantage from social considerations.

Our assessment may be informed by metrics that are relevant to ESG risks, benefits and specific mitigants. These metrics are indicative and are often not available for all rated entities. Metrics also typically vary across different financial sectors (e.g., banks, insurers and asset managers), reflecting varying relevance of particular metrics across sectors and differences in reporting standards and disclosure levels. The metrics are generally found in an issuer's public disclosures or relevant third-party sources. We may also incorporate non-public information.

Our assessment may also take into account the factors and sub-factors in our various sector methodologies. Please see Appendix 2 for a description of the types of indicators that may be generally relevant across financial sectors for informing our assessment of E, S and G risk categories and assigning IPSs for financial institutions.

Over time, we may broaden or adjust our metrics, for example, as more data become available or other indicators are viewed as relevant to our analysis, and we may update these examples. We may also over time add examples of qualitative considerations and metrics for specific financial institution sectors.

The E and S sector heat map category scores provide a general reference for an issuer category analysis. Individual issuers' E and S category scores may vary, potentially significantly, from the sector category scores, as a function of the idiosyncratic characteristics of the issuer.

E and S sector category heat map scores also do not incorporate E and S specific mitigants, which may result in an issuer category score that is better than the respective sector category score.

E, S and G risks may cross multiple categories. For example, carbon transition risks could manifest themselves in our assessments of environmental (e.g., risk of investing in stranded assets) and governance risks (e.g., risk management). Legal and reputational risks may arise in multiple categories: mis-selling or mis-representation of products could drive heightened risks across S and G categories (e.g., weak customer relations, poor controls and greater regulatory oversight). In assigning an E, S or G IPS, we consider the interplay and potential overlap among categories in that component to avoid overstating or understating the risks or benefits.

ESG exposure and the extent to which financial institutions are focused on ESG risks may vary by region, reflecting regional differences in social or regulatory characteristics and the physical environment.

As discussed in Appendix B, the CIS helps to explain the impact of ESG considerations in the context of an issuer's other credit drivers that are material to a given rating.[2]

Issuer Profiles

Environmental Issuer Profile

Environmental considerations are a source of risks for financial institutions. Banks, insurers, funds, asset managers and MDBs are primarily exposed to environmental risks through their investment and lending activities. Insurers are also exposed to environmental risks through their underwriting liabilities, which cover a broad range of risks, many of which are susceptible to environmental risk. Other financial institutions that are not active in lending, underwriting or investing, such as insurance brokers and some securities companies, have generally lower exposure to environmental risk.

Financial institutions have service-oriented, facilities-light business models, with typically modest and diversified physical footprints that limit the exposure of their operating infrastructures to environmental risks; the exposure to such risks is likely to be higher for financial institutions with key operational assets (such as data centers) concentrated in vulnerable locations or using large amounts of energy.

However, environmental risks have the potential to significantly affect financial institutions through their exposures (e.g., the value of investments held, the creditworthiness of counterparties or the value of the collateral securing transactions), and for insurers, also through their underwriting risk exposure. Where broad-based in a region or a country, environmental risks may also negatively impact overall economic growth and society as a whole; they may also affect other sectors, including governments, enterprises and households, to which financial institutions are exposed.

The type of risk exposure varies by institution. Financial institutions that warehouse risks on their balance sheets — mainly banks, MDBs, securities firms, finance companies and insurers — are exposed to the credit and market risk of their invested assets or counterparties. Insurers are also exposed to underwriting risks. Other financial institutions, such as funds and asset managers, which invest mostly on behalf of clients and therefore do not bear the credit or market risk of their investments, are exposed to business and reputational risks related to their customers' response to environmental risk.

Financial institutions are also exposed to regulatory risks and to increased compliance and redress costs through initiatives aimed at reducing or preventing negative environmental trends or hazards and at encouraging increased capital flows into sustainable finance activities.

Growing stakeholder awareness of environmental issues can increase reputational risk; for example, a financial institution may face allegations of contributing to environmental damage because of the activities of the companies or projects it engages with.

Financial Institutions may employ a range of strategies to manage environmental risks. In our assessment of an issuer's exposures to environmental risk, we also form an opinion on the effectiveness of its mitigation strategies and the issuer's ability to implement those strategies. Typical strategies include: (i) diversifying portfolios of loans and investments, the types of insurance underwriting exposures or securities firms' transactions (ii) shifting the business mix toward less exposed activities; and (iii) managing environmental exposure, for example by reducing its duration or by employing hedges or reinsurance.

Financial institutions with portfolios concentrated in sectors highly exposed to environmental risks or with limited flexibility to adjust their exposures (e.g., due to long duration or illiquidity) face higher risks.

2 For the CIS, for banks, the reference rating is the deposit rating or, in the absence of a deposit rating, the senior unsecured or issuer rating. For multilateral development banks the reference rating for the CIS is the senior unsecured rating or issuer rating. For insurers, the reference rating is the Insurance Financial Strength Rating (IFSR). For securities firms, finance companies, insurance brokers and service companies, and pension and asset managers, the reference rating for the CIS is the senior unsecured rating or issuer rating where the entity is an investment-grade issuer, or the corporate family rating (CFR), where the issuer is speculative grade. For government-related issuers (GRIs), the reference rating for the CIS is the issuer rating or senior unsecured rating, while our IPS analysis is based on the standalone operations and characteristics, which, for entities that have a Baseline Credit Assessment (BCA) are also reflected in the BCA.

Conversely, financial institutions engaging in activities less exposed to environmental risks — such as consumer finance or insurance brokerage — and institutions whose investment or lending activity represents a small share of the total business face lower risks.

Environmental factors present more risk than opportunity for most financial institutions. Therefore, a score of 1 for the Environmental issuer profile score or for any of the five categories is unlikely. However, in some cases, environmental considerations can be a source of credit strength. For example, asset managers and MDBs may be able to benefit from rising customer demand for environmentally or more broadly ESG-focused investment products.

In the sections below, we describe the principal credit implications from environmental considerations for financial institutions.

CARBON TRANSITION

Carbon transition risk encompasses policy, legal, technological and market changes associated with a transition to a lower carbon economy.

These changes can have a meaningful impact on counterparties to which financial institutions are exposed. For example, tightening of global or regional regulatory regimes related to carbon dioxide and other greenhouse gases may affect and, in some cases, disrupt the business models and long-term financial and strategic planning of counterparties. The shift to a lower carbon economy may also reduce demand for some counterparties' services, increase compliance costs, necessitate significant investment and diminish expected return on assets. Financial institutions with a high concentration of exposure to affected counterparties, sectors or economies typically have the highest carbon transition risk.

Exposure to counterparties that seek to benefit from carbon transition may also carry risks for financial institutions, in particular where the counterparties have not yet proven the viability of their business model.

Financial institutions also face financial and reputational risks through a failure to adapt to changes in the business environment prompted by higher carbon transition risks. Intensifying focus from a broad range of stakeholders and increasing disclosure requirements elevate these risks.

PHYSICAL CLIMATE RISKS

Physical climate risks principally affect insurers' underwriting exposures, the creditworthiness of financial institutions' counterparties, and the value of invested assets. Rising sea levels, droughts, floods, hurricanes and other extreme weather events have an immediate impact on property and casualty (P&C) insurers' and reinsurers' claims expenses. The increasing incidence of catastrophe losses linked to climate change and the build-up of physical climate risk as a result of chronic, slow-moving trends, create additional underwriting and risk management complexity.

Physical climate risks may also disrupt counterparties' operations, damage infrastructure and commercial and residential properties, as well as negatively affect employment and income levels.

The geographical location of invested assets and counterparties, as well as counterparties' activities, are important considerations because they determine the level of vulnerability a financial institution has to physical climate risks. According to their mandates, many MDBs typically lend to borrowers in emerging and low-income countries, which tend to have high exposure to climate change, although MDBs' diversified portfolios also tend to limit exposure to a particular event. Customer demand for counterparties' products may also be affected by physical climate risks.

WATER MANAGEMENT

Water management focuses on the management and governance of water resources. Climate change considerations such as drought or changing rainfall patterns that could affect water supply are covered under the physical climate risks category.

Water consumption, availability, efficiency and access, pricing, quality and pollution may affect the profitability and asset values of counterparties and investees and, in more extreme cases, a region's overall economy or the finances of a governmental entity. Environmental restrictions may also constrain these entities' ability to operate.

As with physical climate risks, geographical location is an important consideration because certain regions have higher water stress (i.e., a greater supply-demand imbalance), and water shortages can be a destabilizing factor for a wide range of financial institutions' counterparties and investees.

Mismanagement of water resources may also have negative repercussions for the reputation of financial institutions perceived to have financed or otherwise enabled the counterparties that inflicted harm.

WASTE AND POLLUTION

Waste and pollution cover air and land-based waste and pollution, including air pollutants, hazardous and non-hazardous waste, as well as human-caused accidents (spills, leaks and related incidents). This category excludes greenhouse gases not regulated as pollutants, such as carbon dioxide and methane emissions. Water pollution considerations are covered in the water management category.

Waste and pollution principally affect insurance underwriting exposures and manifest as higher claims for P&C insurers and reinsurers. Waste and pollution may also impact the creditworthiness of financial institutions' counterparties — impacted by high clean-up costs, production delays, regulatory compliance and fines — and the value of invested assets. Widespread increases in pollution could affect life and health insurers through higher mortality and morbidity rates; however, these are likely to be somewhat localized.

Financial institutions could also be subject to reputational risks if they are perceived to have facilitated damage to the health of a local population or to natural resources, for example by providing financing or insurance to polluting companies.

NATURAL CAPITAL

Natural capital refers to natural resources that are essential for human habitation and economic activity. Damage from, and costs to avoid, pollutants released into the air and soil are captured in the waste and pollution category. Natural capital risks principally affect the creditworthiness of the financial institutions' counterparties, or the value of the invested assets, or insurance underwriting exposures.

Damage or degradation of the environment can lead to a loss of economic activity and revenue, social backlash, increased environmental compliance costs and regulatory penalties, affecting the creditworthiness of a financial institution's counterparties that rely on natural capital for their business or economic activity. Insurers could be subject to liability claims in cases where their commercial clients are responsible for the damage to natural resources.

Damage or degradation of natural assets may also have negative repercussions for the reputation of financial institutions perceived to have financed or otherwise enabled the counterparties that inflicted harm.

Arriving at the E IPS

To arrive at an issuer's environmental IPS, we typically place the most emphasis on the worst category score. Where risks are additive, we may assign an IPS that is worse than the worst individual category score. However, in assigning the IPS, we also consider the unique characteristics and circumstances of a financial institution, and the interplay and potential correlation among categories. This may lead to assigning a better IPS score than suggested by the worst category score.

Social Issuer Profile

Financial institutions have exposure to social risks and opportunities that arise from their relations and interactions with customers, regulators, governments, employees and other stakeholders, including the public at large, or that stem from the evolution of social trends.

At the same time, banks, finance companies, insurers, funds and asset managers conduct business with many counterparties through lending, insurance policies or investment decisions; where those counterparties have significant exposure to social risks, they could affect these financial institutions' social risk profile.

Social risks can disrupt a financial institution's ability to provide services and can lead to a loss of revenue, additional costs, litigation, regulatory fines and challenges to existing business models. Client trust and confidence are critical for a financial institution, and the inability to address some social risks can weaken its franchise or cause it to lose relevance in the market.

For financial institutions, mitigation through prevention is often more effective than remediation. Once an institution's reputation or brand is damaged, repairing it is typically difficult, lengthy and costly. The implementation of appropriate policies and procedures may help mitigate the risks associated with customer relations and responsible production, while business strategy may help manage changing demographic and societal trends.

In the sections below, we describe the principal credit implications from social considerations for financial institutions.

CUSTOMER RELATIONS

Financial institutions are exposed to customer relations risks through customers' and other stakeholders' perception of the fairness and integrity of their actions and behaviors. Examples include mis-selling and misrepresentation, unfair customer treatment, insufficient disclosures, data security and customer privacy breaches.

Responsible distribution of financial products is an important aspect of customer relations. Mis-selling refers to instances where banks, insurers, funds, asset managers or financial brokers sell overly complex, expensive or illiquid products that may not meet client suitability requirements, or where incentives are used to improperly influence fiduciary decision makers. Misrepresentation refers to inappropriate or insufficient product, service or risk disclosures.

Data security is another critical aspect of customer relations. Data breaches may result in a disruption of services, reputational damage, fines, litigation costs and loss of market share. Financial institutions hold a significant amount of personal data and confidential information, which exposes them to a high degree of potential risk.

Financial institutions that engage in retail activities are especially exposed to customer relations risks because retail business is typically more regulated and subject to regulatory fines. Financial institutions that engage in institutional activities are also exposed to these risks, as both retail and institutional clients can relatively easily and inexpensively move assets and business to a competitor.

Customer relations risks could damage an entity's customer base, brand, reputation and earnings potential, and they could result in fines and legal claims. The resultant franchise erosion would increase the costs of client acquisition and retention.

HUMAN CAPITAL

Human capital risks primarily relate to recruiting, training and retaining employees and maintaining a diverse and inclusive workforce environment.

The recruitment and retention of highly specialized workers is important for financial institutions. Effective policies to attract and retain skilled employees and to maintain constructive staff relations may minimize disputes and disruptive employee actions and help a financial institution adapt more easily to business environment changes.

Hiring and promotion policies that facilitate a diverse and inclusive workplace may help attract talent, and they may support higher profitability and lower risk. External or internal perceptions of a lack of diversity, equity and inclusion, including gender discrimination and unequal compensation structures, may lead to reduced productivity or lawsuits, or they may hurt a financial institution's ability to attract employees.

DEMOGRAPHIC AND SOCIETAL TRENDS

Demographic trends refer to the characteristics of a population. Societal trends largely relate to consumer preferences as well as to government policy agendas and funding.

Both demographic and societal trends may affect financial institutions' revenue and earnings, as well as the way they do business and the products they offer. Geographic and product diversity as well as an ability to quickly adapt to consumer preferences, regulatory changes and societal trends help mitigate these risks or lead to competitive advantages.

Changing demographics require financial institutions to adjust to the financial lifecycles of their customers and the evolving wealth distribution of society. For example, as populations age, demand decreases for banks' traditional lending products but increases for other financial products, such as savings and retirement products by insurers and other financial service providers; a growing customer preference among younger consumers for digital banking or insurance services creates an opportunity to increase revenue but also increases technology costs and exposes financial institutions to competition from new entrants; rising affluence in some countries boosts demand for a range of new financial services, supporting revenue growth; and conversely, a shrinking working age population would curtail demand for some financial products (e.g., mortgages, private pension schemes).

Societal trends create opportunities to expand relevance in the market but also present challenges. For example, policy efforts to increase financial inclusion can provide incremental revenue streams, but institutions may find it difficult to serve these new customers profitably; regulated lending at capped rates may render some business lines uneconomic; mandatory lending may lead to looser credit underwriting standards, weakening asset quality; government requirements for insurers to provide coverage on uneconomic terms may lower their profitability; and institutions perceived to be misaligned with social expectations may experience restricted access to capital.

Less frequent, but highly impactful, is an exposure to social upheavals that lead to severe and prolonged capital flight and a marked weakening of market confidence.

HEALTH AND SAFETY

Health and safety risks relate to the work environments that financial institutions create for their employees and contractors.[3]

Financial institutions typically have low exposure to health and safety risks because they rely on knowledge workers and typically do not expose their employees to the handling of hazardous materials or to machinery and dangerous operating conditions. More relevant health and safety risks for financial institutions relate to employee mental health and well-being, which may impact productivity and the broader reputation of the institution.

Financial institutions can mitigate generally modest risk exposures, for example, by fostering a health- and safety-conscious culture through management and employee training, support and policies, and through compliance with existing regulations.

RESPONSIBLE PRODUCTION

Responsible production refers to the creation of financial products that suitably meet customer needs and the appropriateness of business practices in which financial institutions engage in their day-to-day operations.

Financial products designed to address client needs without undue complexity and risk reduce an institution's exposure to reputational risk and litigation. The extent to which stakeholders, including consumers and local communities, consider a financial institution's products and business practices fair, responsible and inclusive influences the institution's reputation.

Conversely, some financial products are likely to increase an institution's exposure to reputational and litigation risks. For example, the design of complex, opaque or speculative financial products increases the risk of product errors and failure or other unforeseen consequences, including consequences arising from misaligned incentives between a financial institution and its clients. The pursuit of excessive profit margins can lead to products whose benefits do not justify the related costs and risks for customers, and can create incentives for an institution to engage in speculative activities or other behaviors that disadvantage customers, such as churning or front-running, which may generate societal backlash. Similarly, facilitation of illegal activities such as money laundering, bribery and corruption or engaging in reputationally sensitive activities such as tax optimization can negatively impact a financial institution's reputation. Financial institutions' reliance on partners and suppliers of financial and non-financial products (e.g., through open banking) exposes these institutions to risks within their supply chains.

3 We consider health and safety issues that affect the community in which an entity operates under responsible production.

Arriving at the S IPS

To arrive at an issuer's social IPS, we typically place the most emphasis on the worst category score. Where risks are additive, we may assign an IPS that is worse than the worst individual category score. However, in assigning the IPS, we also consider the unique characteristics and circumstances of a financial institution, and the interplay and potential correlation among categories. This may lead to assigning a better IPS score than suggested by the worst category score.

Governance Issuer Profile

Governance is a key consideration for financial institutions because their activities are generally highly confidence-sensitive, particularly in their relationship with counterparties and their funding arrangements, which typically leads to high levels of regulatory scrutiny of many financial institutions.

Governance risk tends to be issuer-driven, compared to environmental and social risks, which may be driven more by external factors and often have a sector-wide impact. Governance is relevant for all financial institutions, regardless of the region in which they operate, although certain governance weaknesses are relatively common for financial institutions in some regions.

The strength of the country's institutions including the rule of law, which is incorporated in our assessment of a sovereign's governance, may be an indicator of governance standards in those jurisdictions, and institutions operating in countries with weak governance standards may themselves exhibit poor governance. However, the G IPS of a sovereign does not directly constrain the G IPS of financial institutions with operations in that country.

The impact of a governance failure can go beyond the immediate consequences, such as financial loss or fines; the consequent reputational damage may lead customers to withdraw funds or to impaired access to market funding, franchise erosion or an enduring loss of business even after the failure has been addressed.

Strong governance is required to mitigate the risk-taking nature of most financial institutions' activities and is supportive of their credit profiles. For example, a robust risk management framework with strong internal controls helps reduce credit, market and operational risks and a variety of other risks, including E or S risks.

In the sections below, we describe the principal credit implications of governance considerations for financial institutions.

FINANCIAL STRATEGY AND RISK MANAGEMENT

Financial strategy and risk management reflect management and board tolerance for risk, which often affects asset, underwriting and funding risks as well as liquidity and capital strategies. This category generally includes consideration of a financial institution's track record with respect to credit, market, insurance and operational risk management, its capital strategy, and its funding and liquidity policies.

The combination of an institution's risk-taking capacity and its risk appetite drives its financial strategy and the long-term sustainability of the institution's investments, lending and underwriting decisions and product offerings.

Risk culture and the risk management framework are key drivers of a financial institution's credit quality. A comprehensive and robust risk governance framework fully embedded in an institution's culture, combined with a holistic view of risks, improve operational effectiveness, generally leading to lower risk. A commitment to a high level of capitalization, diversified funding and strong liquidity often indicates strong governance.

We typically consider that a well-developed risk management framework is embedded in multiple layers of the organization, for example, (i) business lines that own and manage the risks they incur, (ii) risk management and compliance functions that are responsible for providing policies, frameworks and procedures, and for independently measuring, monitoring and reporting risk on an enterprise-wide basis and (iii) an internal audit function that reports to the board on the effectiveness of the risk governance framework and the firm's adherence to policies and procedures.

On the other hand, deficiency of proper risk management and compliance policies, or frequent breaches are indicators of weak corporate governance. This could lead to a deterioration in investing, lending or underwriting discipline, or product failure. Such behavior is also likely to affect the availability and cost of funding of the financial institution. In addition to considering any past governance issues, including regulatory actions (e.g., enforcement actions) or qualified audits in our assessment of Compliance and Reporting (see below), these issues and any enduring remedial actions may inform our assessment of a financial institution's risk culture.

Prudent capital management, evidenced by a willingness and ability to plan proactively for evolving capital requirements and a comprehensive range of stress scenarios, and by an effective economic capital allocation to the institution's businesses, can be an important gauge of the strength of governance.

A clear and robust approach to capital stress-testing is another important indicator of governance strength or weakness. It is one of the foundational risk management and financial strategy tools because it informs decisions related to, for example, how much capital and liquidity to retain to protect creditors or mitigate the impact of market dislocations.

Our assessment of governance is informed by several aspects of a financial institution's risk function, including its suitability to the size, structure, risk appetite, product offerings and overall profile of the institution, the quality and comprehensiveness of risk information systems, measurement tools and practices, and the extent of independence of the risk function.

Business opacity and complexity increase risk management challenges and the need for sophisticated risk management and robust governance. Examples include exposure to opaque long-dated and illiquid assets, obscure counterparties, or complex derivatives and financial products.

M&A strategy, including the materiality and frequency of acquisitions, the strategic rationale and objective of a transaction (e.g., focusing on the core business or shifting to a new business or riskier business mix), and the financial structure of the transaction, may be relevant for the assessment of an institution's financial strategy.

MANAGEMENT CREDIBILITY AND TRACK RECORD

The credibility and track record of management help inform our opinion of its ability to achieve its financial goals and may provide insight into likely future performance, including in stressed situations.

Management's track record for executing the strategy agreed by the board and the volatility of operating results are relevant considerations. An institution that has a track record of anticipating and adapting to evolving business or market conditions generally demonstrates strong management.

Management with extensive experience in managing the business through economic and credit cycles typically has a better understanding of risks and opportunities. Significant shifts in strategy, for example entering a new business or geographic region where management has limited experience, can indicate weaker governance.

A radical departure in strategy, a shake-up in management, disorderly succession planning or an untested management team can all indicate weaknesses in a financial institution's governance.

High executive turnover or a failure to remove senior management despite weak performance may also point to governance risk.

Dependence on one individual or a limited group of executives can pose risk because a loss of key people could adversely impact operations, especially in the absence of a succession plan. Key-person risk often gives rise to weak checks and balances and, in some cases, lax investment, lending and underwriting standards.

Positive and constructive regulatory relationships is a relevant consideration: management's full alignment with the principles of regulation, rather than compliance with minimum requirements, generally leads to stronger management credibility.

ORGANIZATIONAL STRUCTURE

Organizational structure may expose the institution to governance risks. For example, significant cross-shareholdings or frequent changes in organizational structure could obscure performance and the institution's risk exposures.

Organizational complexity increases the financial institution's sensitivity to stress and hinders stakeholders' capacity to fully assess risks. For example, a complex subsidiary structure with offshore holding companies may decrease the visibility of risks or may indicate overly aggressive tax strategies.

Related party transactions may indicate a governance weakness. For example, a financial institution that extends credit to insiders (e.g., management or their affiliated entities) in the form of related-party transactions can create conflicts of interest, reputational damage and, in severe cases, can impair the ability of the financial institution to obtain external financing.

COMPLIANCE AND REPORTING

Strong compliance and control functions and the timeliness and accuracy of reporting are foundational aspects of governance for all financial institutions.

Compliance and reporting issues, including misconduct and know-your-customer and money laundering failings, expose institutions to regulatory actions, sizable financial penalties and prolonged regulatory investigations that can absorb significant resources and management focus, as well as to reputational risks. Reputational risks have the potential to cause shareholders to reduce support.

In our assessment of regulatory compliance, we consider the impact of a regulatory breach, including whether a judgment or penalty is likely to affect an issuer's reputation and access to capital markets, and whether the breach could lead to the loss of license(s) and a consequent inability to operate all or part of the business. We also consider whether the breach is due to an operational issue, a wider governance failure or an intentional management decision as well as the remedial actions in response to the breach.

Our assessment of reporting includes the timeliness, transparency and comprehensiveness of financial statements, restatements of financial data, whether audit opinions are qualified or unqualified, unexpected changes in auditors, and any auditor comments regarding the quality of internal controls. For example, accounting restatements or financial statement disclosures that are weak relative to those of regional and industry peers or not timely may weigh negatively in our assessment of governance.

For all compliance and reporting issues, including incidents of corruption, we may assess the effectiveness of corrective measures undertaken and the timeline to resolution.

Strong compliance and reporting are common for the sector and therefore unlikely to create material incremental credit benefits. As a result, a score of 1 for this consideration is very unusual.

BOARD STRUCTURE, POLICIES AND PROCEDURES

Board oversight and effectiveness are important because boards generally perform a critical role in the supervision of a financial institution's management, strategy and business operations, including setting and monitoring the institution's risk appetite and its risk management framework.

The board's risk committee is important for financial institutions because it sets the risk appetite, oversees the policies and procedures that establish risk controls, approves and monitors overall risk limits, drives risk culture and reviews stress-testing results.

The design, disclosure and oversight of senior management compensation (which is typically set by the board) may provide insights into a financial institution's governance and risk tolerance, based on the incentives. For example, compensation structures without claw-back provisions that provide incentives for short-term outcomes, such as aggressive growth over longer-term soundness, may encourage excessive risk-taking.

Board director independence, levels of relevant experience, diversity, succession planning and turnover are relevant considerations in assessing overall board effectiveness. In assessing a board's ability to understand nascent risks, we may also consider board members' access to external experts and programs that provide continuing education of board members.

Boards of financial institutions with concentrated ownership, influence or control may have more limited checks and balances, which increases the risk of imprudent business practices, such as transactions with related parties not at an arm's length basis. Concentrated ownership or control may also render a board's independent oversight more difficult. In these cases, the board must manage potentially difficult conflicts of interest between the controlling shareholder's interests and those of other stakeholders, including minority shareholders.

A board majority-appointed by a government may encourage financial institutions to engage in transactions to fulfill public policy goals that are not aligned with the economic interest of the institution, leading to higher levels of risk, which may be mitigated by additional governance oversight, early intervention and ongoing support, as is often the case for MDBs and can be the case for government-controlled financial institutions.

Ownership by private equity funds may result in boards with a relatively higher focus on shareholder interests, potentially at the expense of creditors, which may lead to a lower score for this consideration.

Arriving at the G IPS

Risk categories of the G component may be additive, as is the case for the E and S components. However, given the nature of good governance as a potential material credit strength, some related risk categories (e.g., financial strategy and risk management, or management credibility and track record) could offset other governance categories of risks. As a result, we may assign a better G IPS than suggested by the worst category score.

Assessing the Credit Impact Score

The CIS explains the impact of ESG considerations in the context of the other credit drivers that are material to an issuer's rating, as discussed in Appendix B.

Assigning the CIS requires an assessment of other material considerations of a financial institution's credit profile that may create resilience to, or dilute, the exposure.

Substantial non ESG-related credit strengths or external support (e.g., from affiliates or governments) may help to mitigate the impact of ESG exposures on the rating, resulting in a lower CIS in comparison to IPSs.

In addition, the expected time horizon of E and S exposure may mute the effect on the rating (as explained in Appendix B): Financial institutions can have meaningful exposure to risks that are expected to become material over a relatively long time frame; however, they may have sufficient time and financial strength to adapt as needed to meet their ESG challenges.

For financial institutions whose ratings are constrained by the sovereign rating or country ceiling, the credit impact of the exposure reflected in the IPSs, either positive or negative, could dilute the impact these risks and benefits have on the issuer's rating, resulting in a CIS that is low in comparison to the IPSs.

Proposed Appendix 2 – Financial institution Compendium: General Considerations and Indicators

Please click here to access a compendium document that provides a description of the types of considerations and indicators that may be generally relevant across financial institution sectors for informing our assessment of E, S and G risk categories and assigning IPSs for financial institutions.

Moody's Related Publications

Cross-sector credit rating methodologies are typically applied in tandem with sector credit rating methodologies, but in certain circumstances may be the basis for assigning credit ratings. A list of sector and cross-sector credit rating methodologies can be found here.

For data summarizing the historical robustness and predictive power of credit ratings, please click here.

For further information, please refer to *Rating Symbols and Definitions*, which is available here.

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