Rating Methodology of Creditreform Rating AG

Environmental, Social and Governance Score for Banks

Sub-Methodology of Bank Ratings

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Creditreform Rating

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1 Introduction

Creditreform Rating AG (also referred to as "CRA") has been conducting ratings since its inception in 2000 and is a recognized European rating agency.

In order to enable interested parties, investors and the interested public to be able to understand a CRA rating judgement, the present complementary rating methodology (sub-methodology) "Environmental, Social and Governance Score of Banks" is disclosed for the rating of banks. This sub-methodology is dedicated to the analysis of the non-financial factors environmental, social and governance of banks with regard to its sustainability. The extracted consideration of these factors promotes awareness of these factors and does justice to their relevance.

Although ESG risks and opportunities have always been implicitly considered in our rating methodology for banks, CRA now believes that their isolated consideration and presentation leads to further transparency and greater granularity of information.

Banks, as intermediaries between investors and capital seekers, play a central role because of their ability to direct investments. Due to the special characteristics of financial institutions, ESG aspects primarily arise from bank's loan businesses and their activities on the capital market, which in turn are primarily determined by the corporate governance of a bank. For this reason, we generally attach crucial importance to the governance factor in the context of ESG analysis.

Each rating carried out by CRA is based on established principles such as the rating process, basic procedures, fixed rating scales, and additions. This rating sub-methodology, the fundamentals, principles, and the code of conduct of the CRA are freely available on our website (www.creditreform-rating.de). This sub-methodology will be updated in the event of changes in the rating system.

2 Scope of Application

The CRA's **sub-methodology** for assessing a bank's **environmental**, **social** and **governance (ESG) factors** serves as a supplement to the rating methodology for bank ratings and examines a bank's ESG-specific factors with regard to the criteria defined by the CRA. This rating methodology defines the analytical framework and the assessment factors on which the ESG bank score is based on. In addition, this methodology discloses the influence of a bank's ESG factors on the credit rating.

3 Rating Methodology

A bank's ESG score is based on the assessment of the pre-defined factors in terms of their environmental, social and economic sustainability. These ESG factors are defined in the following chapter and are initially assessed separately. Subsequently the evaluation of the individual factors are condensed into an ESG score whereby the factors are weighted according to their relevance with regard to the environmental, social and economic sustainability of a bank (see 3.2 Relevance of ESG factors). The individual factors are assessed based on five level scale (strongly negative, negative, neutral, positive, and strongly positive).

3.1 Assessment criteria of the ESG factors

<u>Environmental (E):</u>

Since banks' business activities are often characterized by lending operations, banks are primarily indirectly exposed to environmental risks and opportunities. On the other hand, banks can control investments through their lending activities and thus have a significant impact on the environment as well as the society. By the factor *Environmental* (E) for banks, we understand and take into account those financing and promotional activities that have or might have an impact on the environmental sustainability. In addition, the exposure (e.g. through excessive lending to certain industries / sectors) of a bank to environmental risks is analyzed as a sub-factor as well. Furthermore, resource efficiency goes hand in hand with a sustainable approach to the environment and is considered as an additional E-factor within a bank's ESG analysis.

1.1) Environmental: Green Financing / Promoting

Green Financing / Promoting is identified by CRA as the first sub-factor of the environmental factor. Under this sub-factor, CRA assesses to what extent sustainable investment opportunities of a bank (e.g. by issuing “Green Bonds") and / or the promotion of environmental protection (e.g. by means of promotional loans / project financing) contribute to environmental sustainability. In addition, a direct impact on business activities can also arise, for example if certain financial products benefit from an increase in demand. Moreover, we take into account to which extent these business areas contribute to the overall activities of the analyzed bank. A positive evaluation in this sub-factor indicates a bank's positive contribution to environmental sustainability through its business activities and vice versa in the case of a negative evaluation.

1.2) Environmental: Exposure to Environmental Factors

Exposure to environmental factors is identified by the CRA as the second sub-factor of the environmental factor. Under this sub-factor, CRA assesses the extent to which a bank's business activities are subject to environmental risks and thus dependent on the environmental sustainability. Moreover, environmental risks can be directly reflected in the increased risk of natural disasters (floods, earthquakes, etc.) due to the specific location of customer projects financed or the bank's own representative offices. On the other hand, environmental risks can be indirectly relevant through business activities such as lending to certain industries / sectors / companies (e.g. oil, gas, aviation, automotive). The assessment of this sub-factor takes into account diversification effects and the business model of a bank. Particularly in extreme cases, this might be a highly relevant sub-factor. A negative assessment in this sub-factor indicates a significant environmental risk or dependence on environmental sustainability. By contrast, a positive evaluation in this sub-factor indicates a low environmental risk or dependence on environmental sustainability.

1.3) Environmental: Resource Efficiency

Resource efficiency is identified by CRA as the third sub-factor of the environmental factor. Under this sub-factor, CRA assesses the extent to which a bank's resource use or resource efficiency contributes to environmental sustainability and thereby analyses the impact of a bank's business activities on its environment. Typically, water, electricity and paper consumption but also CO_2 emissions caused by a bank are considered. In addition, a direct impact on business activities can also occur if, for example, a high level of CO_2 emissions leads to a damage in reputation, a decline in demand and / or higher tax expenditures. Since resource efficiency is usually IT-driven in the financial sector, the assessment in this sub-factor is conducted in relation to the entire banking sector. A positive evaluation in this sub-category indicates a positive contribution of a bank to the environmental sustainability through its business activities and vice versa.

Social (S):

Given the role of banks as economic actors and employers, banks are confronted with social risks and opportunities. By the S-Factor for banks, we understand and take into account the internal components on the one hand and the external components on the other hand. Under the internal component, we consider in particular human capital. In contrast, we consider under the external component a bank's social responsibility towards third parties.

2.1) Social: Human Capital

Human Capital is identified by the CRA as the first sub-factor of the social factor. Under this sub-factor, CRA considers the human capital of a bank. In addition, the behavior of a bank towards its employees with regard to its social sustainability is relevant as well. Moreover, of particular relevance are appropriate qualifications and the protection of employees. Thus, the assessment of this sub-factor takes into account, among others; training opportunities, know-how, employee and health protection, working conditions, compliance with labor law standards, equal rights of men and women and the treatment of whistleblowers. A direct impact on the business activities of a bank can arise in particular from unqualified and dissatisfied employees but also from legal risks. A positive evaluation in this sub-factor indicates a bank's positive contribution to social sustainability due to the positive effects of the human capital sub-factor. In contrast, a negative evaluation in this sub-factor indicates a negative contribution of a bank to social sustainability as defined by the CRA criteria.

2.2) Social: Social Responsibility

Social responsibility is identified by the CRA as the second sub-factor of the social factor. Under this sub-factor, CRA assesses the social responsibility of a bank towards customers, business partners and indirectly affected third parties with regard to social sustainability. Among others, the behavior towards customers and trade unions, protection of human rights and minorities, minimum requirements towards business partners as well as socially beneficial measures such as social housing are evaluated. Direct relevance for the business activities of a bank might arise in particular from the impact on its reputation but also from legal risks. A positive evaluation in this sub-factor indicates a positive contribution of a bank to social sustainability and vice versa.

Governance (G):

The corporate governance determines the business activities of a bank, which in turn, is associated with certain opportunities and risks. By the G-factor for banks, we understand and take into account corporate governance and corporate behavior of banks, which directly or indirectly affect the performance and thus the economic sustainability of a bank. In addition, we consider the transparency and openness of a bank with regard to its business activities as part of the G-factor, which is ultimately the basis for third parties to gain an understanding of the bank's business conduct.

3.1) Governance: Corporate Governance

Corporate governance is identified by the CRA as the first sub-factor of the governance factor. Under this sub-factor, the CRA considers the quality of corporate governance and management, including the management strategy. The particular relevance of these elements arises from its impact on the future business development and thus on the economic sustainability. Moreover, we take into account the extent to which management remuneration is dependent on sustainability aspects, as well as whether there are dependencies on specific individuals and whether gender equality is guaranteed and promoted by the management. A positive evaluation in this sub-factor indicates a positive contribution to economic sustainability of a bank by its governance according the criteria set by CRA's and vice versa in the case of a negative evaluation.

As a rule, CRA attaches the highest relevance to the corporate governance of all ESG factors, due to the highest direct impact on the orientation of a bank's business activities.

3.2) Governance: Corporate Behavior

Corporate behavior is identified by the CRA as the second sub-factor of the governance factor. Under this sub-factor, CRA considers a bank's compliance with established law and business ethics with regard to economic sustainability. Legal compliance is insofar relevant as legal risks can arise with the corresponding consequences. However, proactive measures for compliance are also considered under the analysis in this aspect, such as measures to combat corruption, prevent money laundering, tax honesty or even fair competitive conduct. In contrast, the analysis of business ethics takes into account the extent to which bank's business activities comply with the shared moral beliefs and ethical values of a society. Compliance with data protection can be relevant both in terms of compliance with the law and business ethics. A risk from the point of view of business ethics can be the damage in reputation, which in turn might affect the business activities of a bank as well. For instance, business with questionable regimes or with economic sectors that have fallen into disrepute can be mentioned. A positive evaluation in this sub-factor indicates a positive contribution of a bank's corporate behavior to economic sustainability and vice versa.

3.3) Governance: Corporate Transparency

Corporate Transparency is identified by the CRA as the third sub-factor of the governance factor. Transparency and openness of a bank with regard to its business activities enables third parties to form an opinion on financial and non-financial factors including all business activities. Relevant assessment criteria include the early provision of meaningful annual, disclosure, interim and sustainability reports (including historical reports), and the application of the latest accounting standards. A positive evaluation in this sub-factor indicates a positive contribution to economic sustainability and vice versa in the case of a negative evaluation.

3.2 Relevance and evaluation of ESG factors

CRA assigns the individual sub-factors of the three ESG components a relevance level based on five ascending relevance levels. These relevance levels of the sub-factors are determined with regard to their importance for the overall sustainability (environmental, social and economic) of a bank as well as the banking sector. The following figure describes the existing relevance levels:

Figure 1: Relevance Scale ESG factors

ESG Relevance Scale	
5	Highest Relevance
4	High Relevance
3	Moderate Relevance
2	Low Relevance
1	No significant Relevance

Based on our experience, CRA determines the relevance of each sub-factor in advance of a year as an expert-based industry assessment, but reserves the right to make adjustments during the year in justified cases. If an adjustment is made during the year, it will be explained in the ESG Score Card. The classification of the relevance of each sub-factors is disclosed in the corresponding ESG Score Card as well.

The evaluation of the individual factors is based on five specific levels (strongly negative, negative, neutral, positive, and strongly positive).

3.3 ESG Score

The ESG score is determined based on the relevance and the corresponding assessment of the individual sub-factors, whereby the starting point is an average ESG score.

The degree of relevance determines the weighting of a sub-factor in determining the ESG score. The higher the relevance of a sub-factor, the greater its weighting, whereby identical relevance levels have the same weighting in conducting the ESG score. In contrast, the evaluation of the sub-factors determines the extent to which a sub-factor has a positive or negative impact on the ESG score. A strongly positive / negative evaluation has a higher impact than a positive / negative evaluation. However, a neutral evaluation of a sub-factor has no impact on the ESG Score. It should be noted that a positive / negative evaluation of a sub-factor has a greater impact on the ESG Score than a strongly positive / strongly negative evaluation if the latter one has a lower relevance level.

A bank's ESG score indicates the extent to which a bank's business practices meets the environmental, social and economic sustainability criteria set by the CRA.

The interpretation of the ESG score is shown in the following figure:

Figure 2: Interpretation of the ESG Score

ESG Score Guidance	
> 4,25	Outstanding
>3,5 - 4,25	Above average
>2,5 - 3,5	Average
>1,75 - 2,5	Substandard
< = 1,75	Poor

3.4 Impact on the Credit Rating

The impact on the credit rating of a bank results from the relevance and evaluation of the ESG factors. The greater the importance of a factor, the greater the impact on the credit rating. In contrast, factors rated with a relevance level of "1" and / or "neutral" have no significant impact on the credit rating.

A strongly positive / strongly negative evaluation exerts a stronger influence on the credit rating of a bank than a positive / negative evaluation. However, it should be noted that a positive / negative evaluation of a sub-factor has a greater impact than a strongly positive / strongly negative evaluation if the positive / negative rating has a higher relevance level. Thus, the relevance level is of greater importance.

Key rating drivers are factors that result in a direct change in the credit rating or outlook. If a key rating driver is present at a bank's credit rating in connection with its ESG factors, CRA will present and explain this factor in the ESG Score Card in a transparent manner.