Mining Emerald Green: How ESG Analysis of Borrowers Creates an Advantage in Bank Lending

In our analysis of Rabobank business lending clients, we found a substantially lower credit risk among the companies that perform well on ESG dimensions.

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At a Glance

- As enthusiasm for ESG spreads, analysis of its effect on the credit risk of private companies has been thin—until Bain and Rabobank delved into the bank's commercial loan portfolio.
- Bain found that clients with low ESG performance were about twice as likely to be in arrears as the high ESG performers, all else equal.
- The correlation holds over time even when controlling for size, profitability, and levels of debt, and even when companies start from the same risk rating.
- Banks can use such analysis as the basis to ultimately improve their client management, risk assessments, loan pricing, and funding.

Corporate credit with terms pegged to companies' environmental, social, and governance ratings has taken hold. Europe is at the forefront, but other regions are rapidly catching up. For example, BNP Paribas has signed ESG-linked loan deals with JetBlue Airways, packaging company Crown Holdings, and engineering consultancy WSP Global. Tokyo-based bank SMBC has a similar deal with the US arm of Japanese tire company Bridgestone.

Recent developments in capital markets also indicate a relationship between sustainability and share price performance. Stocks with higher ESG ratings have outperformed the market and shown greater resilience, a correlation that has persisted through the Covid-19 pandemic.

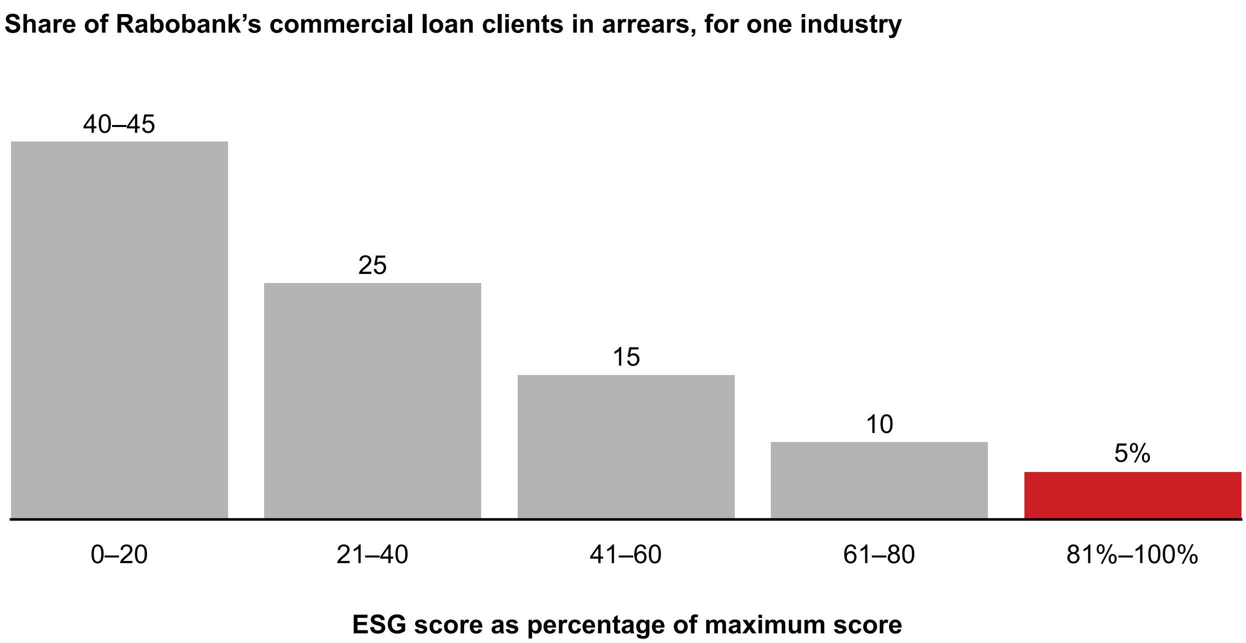
While investment performance of public companies is well researched, analysis of the credit risk of private companies has been thin. Recently, however, Bain & Company applied statistical analysis to a large, representative sample of commercial customers in Rabobank's loan portfolio. Our work confirms a strong relationship between customers' sustainability practices and lower risk of being in arrears *(see Figure 1)*.

The ESG-risk connection

Rabobank gathered ESG information from its 20,000 small and medium-size enterprise clients, using questions specific to their particular industries. Manufacturers, for instance, were asked whether they reused or cleaned waste and water, and which energy-saving measures they took. Agricultural clients were asked about land management and animal welfare. External data such as eco-certifications corroborated the account manager assessment.

Using this data, Bain ranked the companies' ESG performance on a scale of 0 to 100 and analyzed the differences between the top ESG performers and the bottom ones. We used a propensity matching

Figure 1: Stronger performance on ESG dimensions correlates with lower credit risk



Sources: Rabobank; Bain analysis

analysis to control for other factors that can confound results, such as company size, profitability, and levels of debt. For example, more profitable companies have lower risk and more money to invest in ESG initiatives, so we applied the propensity analysis to elicit a pure ESG-risk relationship.

We found that clients with low ESG performance were about twice as likely to be in arrears as the high ESG performers, all else equal. This effect is statistically significant. Separately, we investigated the ESG-risk relationship over time. Low ESG performers were about twice as likely as high performers to move into arrears over the year, even when they started from the same risk rating *(see Figure 2)*.

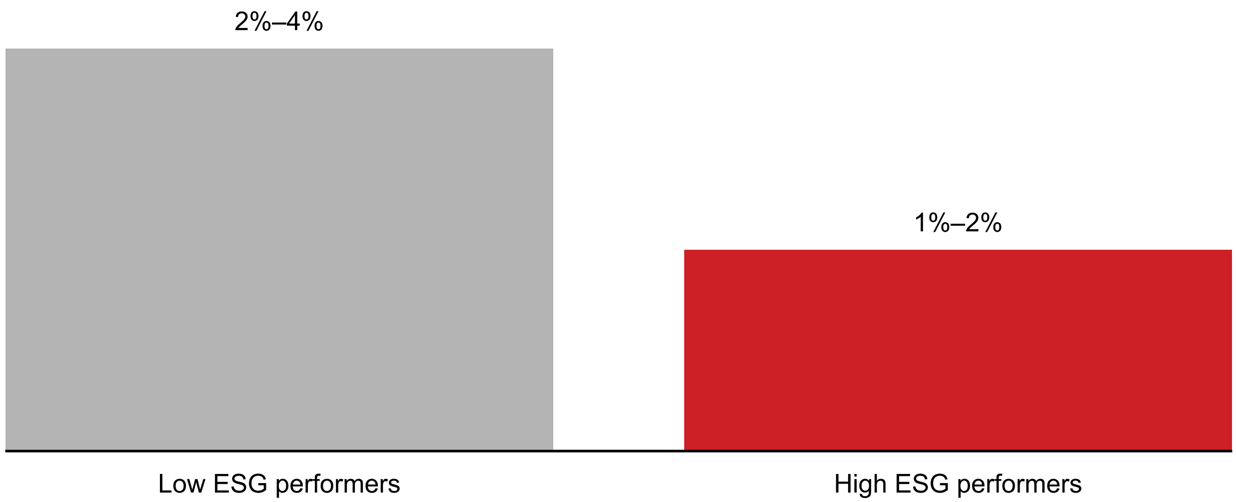
These results indicate a correlation between higher ESG performance and lower credit risk, which for the Rabobank portfolio holds across different geographies and industries. We will continue to investigate the connection between sustainability and credit risk, using data over a longer period and possibly more control variables.

The role of management

Exactly why sustainability correlates with lower risk is difficult to prove statistically, because of the qualitative factors involved. Interviews with account managers, combined with our experience working with other banks on ESG-related initiatives, suggest that the quality of management plays an important role.

Figure 2: The correlation holds even when companies start from the same risk rating

Share of Rabobank's commercial loan clients that moved into arrears, starting from the same average risk rating the prior year



Sources: Rabobank data; Bain analysis

Higher-caliber management establishes business models that foster financial stability and sustainability. Such investments can lead to greater operational efficiency, by reducing by-products and waste and by more efficiently allocating resources. In turn, efficient resource allocation improves a firm's financial health and lowers its default risk.

For example, Rabobank sees that Dutch organic grocery chain Ekoplaza actively focuses on reducing food waste by optimizing its supply chain and donating produce that is almost out of date. Overall, the bank's ESG-focused clients tend to have more efficient, long-term-oriented operations and thus pose a lower credit risk for the bank.

Using ESG analysis to improve the business of lending

Given the durable connection between sustainability and risk, banks have an opportunity to improve their lending business through client management, risk assessments, loan pricing, funding, and, in the future, potentially capital models.

Advanced client management. Client dialogues should expand to cover how performance on ESG dimensions affects the risk of default or falling into arrears, as well as the long-term benefits. The choice of clients can start with companies that have a relatively low ESG score but strong financials and senior managers willing to make changes. A bank can steer this effort centrally by, for instance, focusing on industries in which regulation or customer priorities call for ESG initiatives.

Enhanced risk assessment. Adding in-depth analysis of ESG variables will increase the accuracy of risk models, enabling banks to make more informed judgments about each client's risk profile. And a better assessment of credit risk can give banks a competitive edge.

Adjusted loan pricing. Financial incentives will help motivate clients to invest in sustainability. Rabobank has reduced the price of loans to high ESG performers such as Ekoplaza. Better pricing could serve as a commercial strategic advantage for banks.

Improved funding cost. Funds have already been made available for ESG investment from sources such as Europe's central banks. The latest initiative includes a fund launched by the Bank for International Settlements for green-bond investments by central banks. Investor demand for sustainable assets currently outstrips supply, so a bank that can securitize and sell its ESG-intensive loans will be able to obtain cheaper funding.

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Many banks clearly want to further ESG goals in their own and their clients' activities. Recently, 43 major banks formed the Net-Zero Banking Alliance, convened by the United Nations to support the transition of the real economy to net-zero emissions. Rabobank's experience should give banks confidence that they can help attain these lofty goals, and improve their economics in the bargain, by analyzing and working with the private companies in their own portfolios.

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