

Environment Social and Governance (ESG) Factors in Credit Ratings for Financial Institutions

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Executive Summary

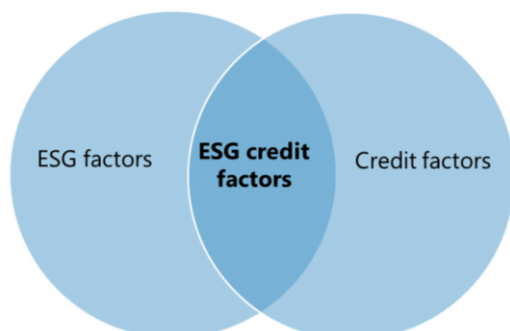
PEFINDO views the integration of environmental, social, and governance (ESG) factors into rating assessments as essential to ensuring a comprehensive evaluation of the risks and opportunities that may affect a company's business and financial performance. Effectively addressing ESG considerations can enhance a company's competitive position by enabling it to capture emerging market opportunities ahead of its peers or mitigate risks stemming from exposures to debtors, partners, or counterparties vulnerable to ESG-related challenges. While the incorporation of ESG factors does not necessarily lead to changes in a company's rating, it allows us to capture relevant ESG-driven risks and opportunities within our analytical framework.

This article outlines our approach to addressing ESG factors and their integration into our rating methodology for the financial institution sectors, including banking, financing, insurance and guarantee, as well as other sectors such as securities, asset management, and financial market infrastructure. It highlights ESG and credit considerations that may affect an institution's business and financial performance, whether positively, negatively, or neutrally, in relation to the key success factors defined in our methodology. Given that financial institutions typically experience ESG impacts indirectly through their customers, investment or loan portfolios, and counterparties, rather than through direct operational exposure as seen in corporate sectors, this article also provides illustrations of how ESG factors may influence the financial sector.

ESG Credit Factors

ESG factors generally relate to how environmental and social dimensions affect an industry, as well as the quality of governance practices at the company level. Within our rating methodology, the core objective is to assess a company's capacity to meet its financial obligations as they become due. Accordingly, we identify ESG credit factors as those ESG-related elements that may directly influence a company's business profile or financial metrics in a way that affects its ability to service debt. Only ESG factors that have a clear, observable, and credit-relevant impact on a company's performance are incorporated into our assessment of ESG credit considerations.

Diagram 1. ESG Credit Factors



The following section outlines the ESG factors and their associated subfactors that may influence the credit quality of a rated entity. While certain ESG subfactors may have limited or no direct relevance to the key success factors in our financial institutions methodology, others may affect one or more of these factors in a meaningful way. Further explanations and illustrative examples are provided in the following discussion.

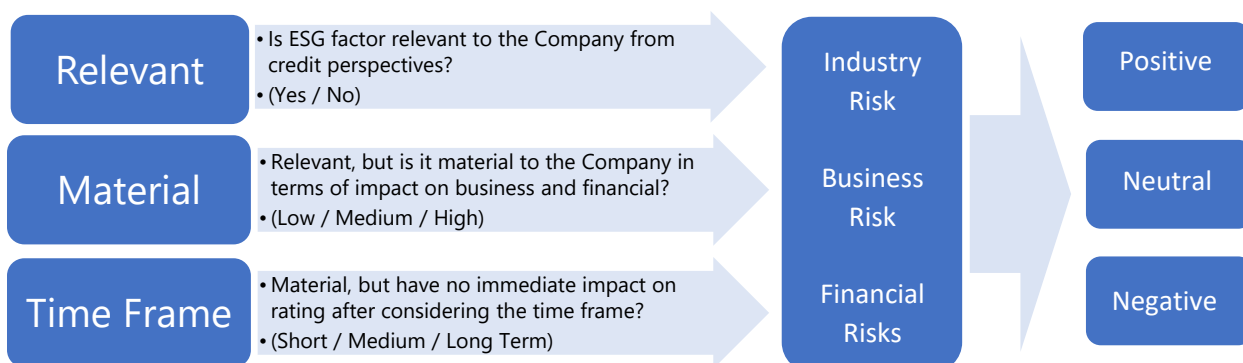
Diagram 2. ESG Factors and Subfactors



In assessing ESG credit factors, three key dimensions are considered: relevance, materiality, and time frame. Not all ESG factors are relevant to the creditworthiness of a rated entity. Even when a factor is relevant to the broader industry, it may not be material to a specific company's business or financial indicators; its materiality can vary from low to moderate to high, depending on the company's exposure and management response. Once a factor is determined to be both relevant and material, the next step is to evaluate its time frame, assessing whether its potential impact on credit risk is likely to emerge within the rating timeframe, which is typically around three to five years.

After evaluating the relevance, materiality, and time frame of each ESG factor, the next step is to determine the nature of its impact on the company's credit quality. A positive impact indicates that the factor influences one or more key success factors. Conversely, a negative impact reflects a detrimental influence on one or more key success factors, potentially weakening credit quality. In some cases, the impact may be neutral, meaning the ESG factor does not materially affect the company's credit quality, or its influence on any key success factor is minimal or indirect.

Diagram 3. ESG in Credit Rating Analysis Flow



ESG Sectoral Analysis and Illustration of the Impact

Not all ESG subfactors exert a material influence on the financial institution sectors, unlike in the corporate sectors, where most subfactors tend to be more broadly impactful. Within our methodology, the financial institution sectors encompass several subsectors, including banking, financing, insurance and guarantee, as well as other financial services such as securities, asset management, and financial market infrastructure. In the following sections, we outline the relevant ESG subfactors for each subsector and assess how they may influence the creditworthiness of the respective financial institutions' subsectors.

Environment

Although environmental factors are generally the least material for the banking and financing sectors, they can still indirectly affect banking operations, particularly through physical climate risks. Banking and financing sectors with significant loan exposure to sectors such as mining may face elevated credit risks when extreme weather events, such as heavy rainfall, flooding, or drought, damage debtor infrastructure or disrupt debtor's operational activities. Such disruptions can impair debtors' repayment capacity. For banks or companies with concentrated lending portfolios, these climate-related events can further intensify asset quality pressures.

On the other hand, exposure may originate from infrastructure financing projects that rely on land availability, water access, or other natural resources, where regulatory hurdles or delays in obtaining permits can disrupt project timelines or elevate development costs. These challenges can diminish the debtor's cash-flow capacity and heighten repayment risk, especially for projects with narrow financial headroom. From a rating standpoint, such conditions may lead to weaker asset quality, higher credit costs, and increased provisioning requirements for the financing institution, thereby pressuring its overall financial profile.

Table 1. Illustration of environmental subfactors impacting credit quality

	Carbon regulation and transition risk	Physical climate risk	Waste and pollution	Capital and natural resources
Banking (commercial banks, sharia banks, regional banks, rural banks)	This ESG subfactor is not relevant or material and does not directly affect the current timeframe.	Physical climate risks, such as heavy rainfall, flooding, and drought, that disrupt a debtor's operations may weaken its repayment capacity, thereby exerting pressure on the bank's asset quality.	This ESG subfactor is not relevant or material and does not directly affect the current timeframe.	This ESG subfactor is not relevant or material and does not indirectly affect the current timeframe.
Financing (automotive financing, non-automotive financing, infrastructure financing, leasing, MSME financing)	This ESG subfactor is not relevant or material and does not directly affect the current timeframe.	Physical climate risks, such as heavy rainfall, flooding, and drought, that disrupt a debtor's operations may weaken its repayment capacity, thereby exerting pressure on the leasing's asset quality.	This ESG subfactor is not relevant or material and does not directly affect the current timeframe.	Exposure stems from infrastructure financing projects that rely on land, water, and other natural resources, where regulatory constraints or permitting delays may hinder project execution or elevate costs, ultimately

				weakening debtor cash flows and further pressuring the company's asset quality.
Insurance and Guarantee (life insurance, general insurance, reinsurance, sharia life and general insurance, guarantee companies)	This ESG subfactor is not relevant or material and does not directly affect the current timeframe.	Physical climate risk affects certain insurance and reinsurance business lines, such as marine hull and marine cargo, where climate-related disruptions can elevate the claim ratio, which may deteriorate an insurer's operating performance.	This ESG subfactor is not relevant or material and does not directly affect the current timeframe.	This ESG subfactor is not relevant or material and does not indirectly affect the current timeframe.
Other Financial Institutions (securities, asset management, and financial market infrastructure)	This ESG subfactor is not relevant or material and does not directly affect the current timeframe.	Physical climate events, such as floods, storms, extreme heat, or power outages, may cause trading or clearing disruptions in an institution's operations, thereby elevating operational vulnerabilities and contributing to higher business risk assessments.	This ESG subfactor is not relevant or material and does not directly affect the current timeframe.	This ESG subfactor is not relevant or material and does not indirectly affect the current timeframe.

Social

Social factors also influence financial institution sectors, particularly for companies with a strategic focus on the MSME and micro segments. Customer behavior, demographic trends, and community trends can significantly impact a company's financial profile. Banks and financing companies with substantial exposure to MSME and micro borrowers may experience increased asset quality risks, as these segments are generally more susceptible to macroeconomic volatility. While such lending often supports higher margins, it is typically accompanied by elevated operating costs due to the need for intensive customer engagement, including servicing borrowers in remote or underserved areas.

From another consumer-relations perspective, data protection has become an increasingly significant consideration, particularly given the rising incidence of cybercrime. Financial institutions are highly susceptible to reputational damage when data breaches occur, as public trust is a critical foundation of their business operations. Such incidents can erode customer confidence and negatively impact a company's competitive position. In addition, poor service quality or the mis-selling of financial products can further undermine public trust and negatively impact a company's business position.

Table 2. Illustration of social subfactors impacting credit quality

	Health and safety	Employee relation	Consumer relations, demographic and community trends
Banking (commercial banks, sharia banks, regional banks, rural banks)	This ESG subfactor is not relevant or material and does not directly affect the current timeframe.	This ESG subfactor is not relevant or material and does not directly affect the current timeframe.	Data breaches, cyber incidents, and poor service quality can undermine a bank's reputation, thereby heightening its business risk profile. Exposure to MSME segments, which generally have weaker credit profiles, can place pressure on a bank's asset quality and profitability, particularly when higher operational costs and narrower margins are insufficient to absorb the associated risks.
Financing (automotive financing, non-automotive financing, infrastructure financing, leasing, MSME financing)	This ESG subfactor is not relevant or material and does not directly affect the current timeframe.	This ESG subfactor is not relevant or material and does not directly affect the current timeframe.	Exposure to MSME segments, which generally have weaker credit profiles, can pressure the company's asset quality and profitability, particularly when elevated operational costs and narrower margins are insufficient to absorb the associated risks.
Insurance and Guarantee (life insurance, general insurance, reinsurance, sharia life and general insurance, guarantee companies)	This ESG subfactor is not relevant or material and does not directly affect the current timeframe.	This ESG subfactor is not relevant or material and does not directly affect the current timeframe.	Product mis-selling in the life insurance sector may undermine reputation and public trust, potentially affecting business performance in the short to medium term.
Other Financial Institutions (securities, asset management, and financial market infrastructure)	This ESG subfactor is not relevant or material and does not directly affect the current timeframe.	This ESG subfactor is not relevant or material and does not directly affect the current timeframe.	Data breaches, cyber incidents, and poor service quality can undermine a company's reputation, thereby heightening its business risk profile.

Governance

Financial institutions are generally more exposed to governance than to environmental or social factors, primarily due to their reliance on public trust, stringent regulatory oversight, and the complexity of their operations. Weak governance structures can lead to conflicts of interest, undermine underwriting discipline, and ultimately compromise asset quality and profitability. These challenges are particularly evident in regional banks, which are typically owned by local governments and may face governance issues stemming from ownership dynamics. In such cases, management decisions can be influenced by regional authorities, constraining risk appetite and reducing operational independence.

Risk management and oversight are critical components of the financial institution sector, as weaknesses in these areas can significantly affect a company's reputation and long-term financial performance. For banks and financing companies, ineffective risk controls can lead to deteriorating loan quality, while for

insurers, poor investment oversight may compromise portfolio resilience. In the securities and asset management sectors, inadequate supervision can increase the likelihood of litigation and regulatory breaches. Ultimately, the sustainability and stability of a financial institution depend on the effectiveness of its risk-management framework and the consistent execution of oversight across its business operations.

Financial institutions operate under stringent regulatory oversight, making transparency in financial reporting and disclosures essential for all stakeholders. Weak transparency or poor reporting quality, such as inconsistent data provided to third parties, can undermine a company's credibility and damage its reputation. Significant financial statement restatements or inadequate disclosure of new accounting standards, as observed in parts of the insurance sector, may directly affect a company's financial performance. In the securities and asset management sectors, insufficient transparency and unreliable reporting can further erode investor confidence, potentially triggering fund withdrawals.

Table 3. Illustration of governance subfactors impacting credit quality

	Governance structure	Risk management and oversight	Transparency and reporting
Banking (commercial banks, sharia banks, regional banks, rural banks)	Regional banks, often owned by local governments, face governance challenges arising from their ownership structure, where management decisions may be influenced by regional authorities, limiting risk appetite and operational independence.	Fraud, weakened oversight, and inadequate risk management can heighten asset-quality risks and lead to significant losses, ultimately undermining a bank's profitability.	A significant restatement of financial statements may affect its current financial performance.
Financing (automotive financing, non-automotive financing, infrastructure financing, leasing, MSME financing)	Weak governance structures can expose the company to conflicts of interest, improper risk transfer, or decision-making that undermines financial stability. Governance deficiencies may also affect underwriting practices, which, if prolonged over time, can erode asset quality.	Weakened risk management and oversight can lead to elevated credit losses, particularly given the sector's exposure to retail and MSME segments, which inherently carry higher credit risk.	Weak transparency and reporting practices, inconsistent income or expense recognition, and unclear disclosure of related-party transactions can lead to significant volatility in financial performance, such as asset quality or profitability.
Insurance and Guarantee (life insurance, general insurance, reinsurance, sharia life and general insurance, guarantee companies)	Shareholder intervention in an insurer's underwriting decisions can weaken underwriting discipline, potentially increasing claims and leading to deteriorating operating performance.	Weak risk management and oversight, particularly when investment committee processes are not properly applied, can lead to investment losses, with insufficient mitigation mechanisms to absorb the associated risks.	Non-sharia insurance and reinsurance companies are subject to the implementation of PSAK 117, which may materially affect their financial statements. For insurers with long-term contracts, the transition could create significant reserve adjustments, potentially impacting their capitalization profiles and operating performance indicators.
Other Financial Institutions (securities, asset management, and financial market infrastructure)	Failure to execute corporate strategy due to potential conflicts of interest between stakeholders and management can result in unstable income or expenses	Litigation arising from governance weaknesses, such as vulnerabilities to money laundering or cyber risks, can undermine the company's business position.	The accuracy, clarity, and transparency of an asset manager's disclosures are critical to maintaining stable fund inflows and outflows. Incomplete or inaccurate information can prompt investor withdrawals and may

	in securities and asset management companies.		weaken overall business stability.
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Communication of ESG Result: Presentation in the Report

PEFINDO continues to incorporate ESG considerations into our credit assessments and reflect them transparently in our rating rationales. A dedicated section is included to explain how we evaluate the most relevant ESG subfactors and their influence on the key success factors of a rated entity. We also indicate whether these ESG factors have a positive, neutral, or negative impact on the relevant credit factors. While this assessment does not necessarily result in a rating change, it provides clarity on how ESG considerations may affect the company, the extent to which these risks are mitigated, and our overall view of their potential influence during the rating period.

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