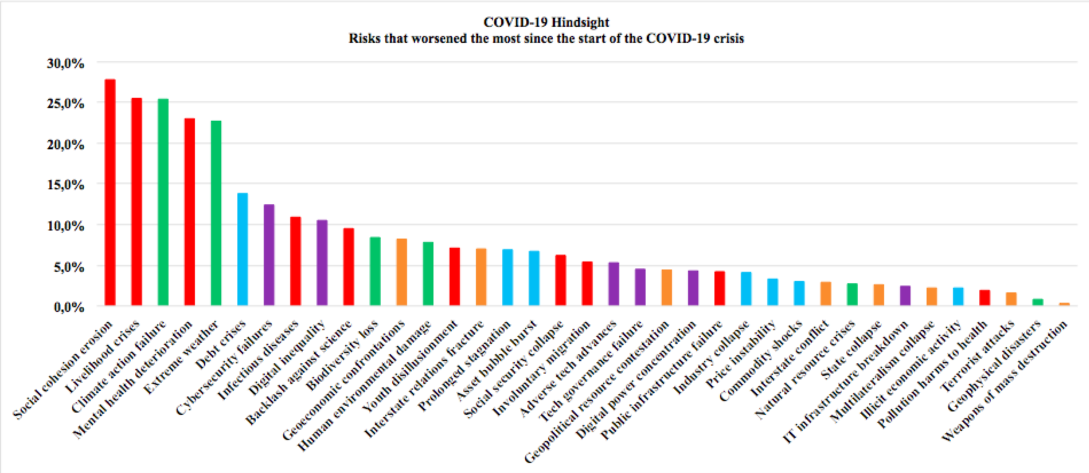
CHAPTER I

INTRODUCTION

1.1 Background of the Research

The whole world is currently struggling to recover from the effects of the unprecedented COVID-19 pandemic. The recovery from uncertain economic conditions in 2021 will become even more bleak as risks begin to appear increasingly real in 2022. Based on the 'Global Risk Report 2022' published by the World Economic Forum which states that there are the top ten the most severe risks on a global scale over the next 10 years that are most likely to be faced by humanity: climate action failure, extreme weather, biodiversity loss, social cohesion erosion, livelihood crises, infectious disease, human environmental damage, natural resources crises, debt crises, and geoeconomics confrontation. Specifically, in 0-2 years, there are several risk that will become a critical threat to the world: extreme weather (31.1%), livelihood crises (30.4%), climate action failure (27.5%), social cohesion erosion (27.5%), infectious disease (26.4%), mental health deterioration (26.1%), cybersecurity failure (19.5%), debt crises (19.3%), digital inequality (18.2%), and asset bubble burst (14.2%). Figure 1.1 shows the worsenest risk since the start of the COVID-19 crisis.



Source: Data processed by researcher from 'Global Risk Report 2022' published by the World Economic Forum

Figure 1.1

The Worsenest Risk Since The Start Of The COVID-19 Crisis

Based on the explanation above, the highest risk that will be faced in 0-2 years in the economic sector is debt crises (19.5%). This condition is related to the operational activities of the global banking industry. Therefore, the banking industry has a major role in the global economic recovery from the COVID-19 pandemic. Banks not only play a role in providing assistance and maintaining financial stability through continuous daily operations, but also opening up their balance sheets to lend. McKinsey in the ‘2021 Global Banking Annual Review’ explained that loan growth in the banking industry reached 11% in 2020, driven by China at 20% and Europe at 9%.

The financial industry, especially banking, has an important role for industries engaged in other real sectors (goods and services from the real sector) in achieving their business goals. There are several banking activities that directly affect the real sector: credit screening activities; credit rationing; creating liquidity and maintaining the liquidity; bank loans commitments, lines of credit, and guarantees help facilitate trade and investment activities; debt restructurings; and play a feedback role when they supply information about their corporate clients. The role of the bank as a lender makes the bank must have a good financial condition. One of the indicators used to measure financial condition is credit rating.

A credit rating is an index that indicates the credit risk of a firm or a debt and it can determine the incurred cost (interest rate) when using capital from others in the market (Kim and Kim, 2022). Credit ratings have an important role in the operational activities and investment decisions of companies, especially banking companies. Banking companies with high credit ratings tend to have better financial performance. Credit rating is also one of the factors that can affect customers in carrying out credit activities with banks. Customers who have large and open loans can be affected if the bank's creditworthiness changes or even decreases. Therefore, banks need to maintain liquidity because it can affect credit activities and credit ratings of the bank.

The assessment and provision of credit ratings for companies is carried out by credit rating agencies. Currently, there are three leading credit rating agencies in the world: Fitch Ratings, Moody's Investor Services, and Standard & Poor's. This research uses International Credit Rating Scales from Fitch Ratings. This choice has several reasons: Fitch Ratings was the first credit rating agency that introduced the AAA-D rating system in 1923 which has since become the basis for ratings throughout the industry until nowadays; and the use of International

Credit Rating Scales from Fitch Ratings also because the research sample is global banking companies.

The Stockholm Declaration 1972 is the very first UN Conference that relates to environmental issues. This declaration set the governance fundamental principles for sustainable resources. Even though this declaration had set it, the natural conditions half a century later remained a serious matter. This condition is triggered by companies, organizations and individuals who view natural resources as a key asset that can drive development and increase wealth. Over time and with progressive industrialization, resource use increased. In some cases, exploitation levels came to exceed resources' natural regeneration rates (Bansard and Schröder, 2021). They only focus on financial conditions and neglect sustainability in running their operational activities. This condition makes the theme that relates to sustainability has always become an important issue in economic discussion worldwide.

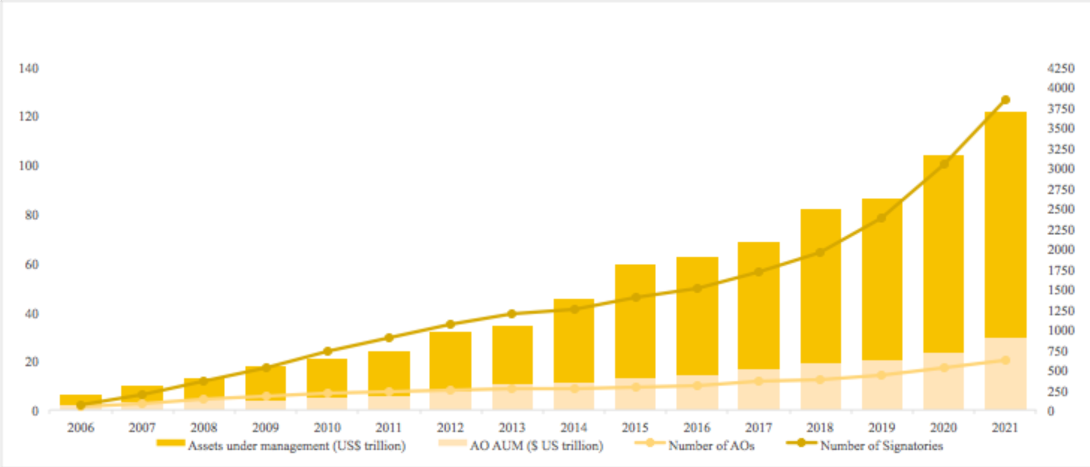
Departing from the various existing problems above, in 2006 the Principles for Responsible Investment (PRI) were formed in New York. The Principles for Responsible Investment (PRI) is an international investor association that has a common goal of implementing six principles of sustainable responsible investment. The six principles are based on the estimate that Environmental, Social, Governance (ESG) activities can affect the investors' investment portfolio. Environmental, social, and governance (ESG) is an investment concept used by socially conscious investors to screen potential investments considering the company's behavior related to sustainability standards (Investopedia, 2022). According to Kiesel and Lücke (2019) ESG is a set of nonfinancial information that considers the performance and risk exposure of the company related to sustainability topics.

This research uses the Refinitiv Eikon database for analyzing the sustainable performance. ESG ratings in the Refinitiv Eikon database are available on over 12,000 public and private companies globally, with time series data going back to 2002. Refinitiv Eikon database has 10 categories to analyze all of the ESG pillars. Each category has several themes that are used as the basis for Refinitiv Eikon database calculating the score of each pillar in the ESG. These ten categories are used as independent variables which are also used to measure sustainability performance in this research.

The first pillar of ESG is environmental that consists of three categories: emissions, innovation, and resource use. The emissions reduction score describes the commitment and effectiveness of the company to reduce environmental emissions in its production and operational process (Refinitiv Eikon, 2022). The innovation score reflects the capacity of the company to reduce the environmental costs and burdens for its customers, thereby creating new market opportunities through new environmental technologies and processes, or eco-designed products (Refinitiv Eikon, 2022). The resource use score describes the performance and capacity of the company to reduce the use of materials, energy or water, and to find more eco-efficient solutions by improving supply chain management (Refinitiv Eikon, 2022).

The second pillar of ESG is the social pillar that consists of four categories: community, human rights, product responsibility, and workforce. The community scores describe the commitment of the company to being a good citizen, protecting public health and respecting business ethics (Refinitiv Eikon, 2022).The human rights score describes the effectiveness of the company in terms of respecting fundamental human rights conventions (Refinitiv Eikon, 2022). The product responsibility score measures the capacity of the company to produce the goods and services with high quality, integrating the customer's health and safety, integrity and data privacy (Refinitiv Eikon, 2022). The workforce score describes the effectiveness of the company in terms of providing job satisfaction, a healthy and safe workplace, maintaining diversity and equal opportunities, and development opportunities for its workforce (Refinitiv Eikon, 2022).

The last pillar of ESG is the governance pillar that consists of three categories: CSR strategy, management, and shareholders. The CSR strategy score reflects a company's practice to communicate that it integrates economic (financial), social, and environmental dimensions into its day-to-day decision-making process (Refinitiv Eikon, 2022). The management score reflects the commitment and effectiveness of the company to following the best practice of corporate governance principles (Refinitiv Eikon, 2022). The shareholders score describes the effectiveness of the company towards equal treatment of shareholders and the use of anti-takeover devices (Refinitiv Eikon, 2022).



Source: Data processed by researcher from Principle for Responsible Investment official website (www.unpri.org)

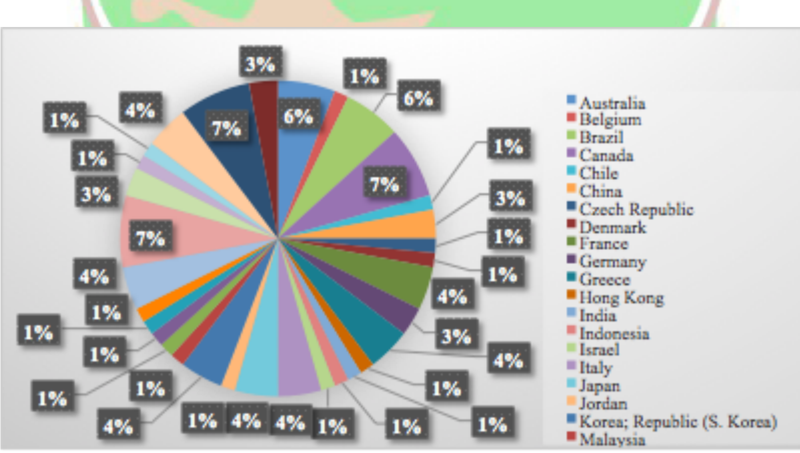
Figure 1.2

The Principle for Responsible Investment growth from 2006-2021

Based on figure 1.2, there is a significant increase of PRI growth from 2006 until 2021. Sustainable finance applies ESG principles in various business decisions and investment strategies. This is evidenced by the fact that in 2021 there will be a three-fold increase in ESG-based debt issuance to $190 billion and sustainability-related equity flows also increased, to $25 billion, bringing total assets under management to nearly $150 billion (Goel et al., 2022).

This research also uses control variables. Based on previous research, there are two control variables that are most widely used in research that are related to ESG, sustainability performance, and credit ratings: firm size and profitability (Zanin, 2021), (Safiullah et al., 2021), (Kim and Hong, 2020) (Putra and Adrianto, 2020). Firm size is commonly used as a fundamental firm characteristic in analyzing corporate finance (Dang and Li, 2015). Firms with larger size will face lower financial risk and have higher credit ratings (Safiullah et al., 2021). This research uses the total asset of the company to measure the firm size. Profitability is a main goal of all the businesses because without profitability the business can not survive in the long term. It is important for the business to calculate the current profit and project the future profit of the business. This research uses a return on asset (ROA) ratio to measure profitability.

Based on the explanation above, the significant changes in global conditions have forced all industries - including banking industry - to apply the concept of sustainability in their operational activities. It may also have an impact on the company's financial performance, including the credit rating. Therefore, this research will take the global banking industry as the research sample. There are 2008 banking companies that are listed on the stock exchange worldwide from 2012-2021. But only 56 banking companies from 20 countries from 2012-2021 fit with the sample's criteria and can used as research sample that shows on Figure 1.3 below.



Source: Data processed by researcher from Refinitiv Eikon database

Figure 1.2

Research sample based on the company's country

There are several previous research that are related on sustainable performance and credit rating: Safiullah et al. (2021), Lee (2022), Barth et al. (2021), (Zanin, 2021), Das et al. (2022) Lee (2022) Zheng et al. (2022) Griffin et al. (2018). However, most of the research only conducted research in general or selected certain categories (such as environmental pillars only). There is no research that analyzes each category that makes up each ESG pillar and its effect on credit rating. Therefore, this research will develop the previous research specifically to see the effect of each category on credit rating. This specific test is needed to find out what factors from ESG will have a significant influence on the company's credit rating. Thus, the company can maximize its sustainability performance to improve the company's financial performance, especially the company's credit rating. Therefore, the title of this research is **'THE EFFECT OF SUSTAINABILITY PERFORMANCE ON CREDIT RATINGS IN GLOBAL BANKING INDUSTRY'**.

1.2 Problem Statements of the Research

The problem statement of this research are:

1. How does emissions score impact corporate credit ratings?
2. How does innovation score impact corporate credit ratings?
3. How does resource use score impact corporate credit ratings?
4. How does community score impact corporate credit ratings?
5. How does human rights score impact corporate credit ratings?
6. How does product responsibility score impact corporate credit ratings?
7. How does the workforce score impact corporate credit ratings?

8. How does CSR strategy score impact corporate credit ratings?
9. How does management score impact corporate credit ratings?
10. How do shareholders score impact corporate credit ratings?

1.3 Objectives of the Research

According to the state of the problem above, the aims of the research are:

1. To determine the impact of emissions score on corporate credit ratings.
2. To determine the impact of innovation score on corporate credit ratings.
3. To determine the impact of resource use score on corporate credit ratings.
4. To determine the impact of the community score on corporate credit ratings.
5. To determine the impact of human rights score on corporate credit ratings.
6. To determine the impact of product responsibility score on corporate credit ratings.
7. To determine the impact of workforce score on corporate credit ratings.
8. To determine the impact of CSR strategy score on corporate credit ratings.
9. To determine the impact of management score on corporate credit ratings.

10. To determine the impact of shareholders score on corporate credit ratings.

1.4 Contribution of the Research

The contribution which expected from this research are:

1. Theoretical Contribution
    a. For Academics

        This research is expected to be useful in adding knowledge and insight, as well as being a reference for future research on similar topics.

    b. For Author

        This research is useful in applying the knowledge that has been obtained and can understand about sustainable performance and credit rating.

2. Practical Contribution
    a. For Company

        This research can be used as a reference in determining policies related to sustainability and credit ratings.

    b. For Investors

        This research can be used as additional information for investors for consideration or reference before making a decision to invest in a company.

1.5 Research Scope

This research is limited by the sample and certain variables which aims to avoid a confusion in the discussion of the result of the analysis. According to the title of the research "The Effect Of Sustainability Performance On Credit Ratings In Global Banking Industry" there are several variables which are used in this research. The sample used in this study is banking companies around the world that have complete categories scores in all ESG pillars on the Refinitiv Eikon database and have credit ratings that are assessed by Fitch Ratings from 2012-2021. The independent variables of this research are Emissions score, Innovation score, Resource Use score, Workforce score, Human Rights score, Community score, Product Responsibility score, Management score, Shareholders score, and CSR Strategy score. Meanwhile, the dependent variable which is used in this research is Credit Ratings. In addition, this research is also using firm size and profitability as control variables.

1.6 Research Outline

There are five chapter on this thesis research that will be arranged chapter by chapter as mentioned below:

CHAPTER I : INTRODUCTION

The first chapter of this thesis research will give some information about background of the research, problem statements of the research, objectives of the research, contribution of the research, research scope, and research outline.

CHAPTER II : LITERATURE REVIEW

The second chapter of this thesis research will explain about the theories that were used in this research, the previous research, hypothesis development, and conceptual framework.

CHAPTER III : RESEARCH METHOD

This chapter consists of research design, research population and samples, types and sources of data, operational definitions of variables, data collection methods, and data analysis methods.

CHAPTER IV : RESULT AND ANALYSIS

This chapter contains the results of the research and its discussion. In addition, this chapter will explain the analysis of the results and see the comparison of the results carefully with the criteria used to prove the assumptions of the research hypothesis.

CHAPTER V : FINAL PART

This chapter contains conclusions from the results of research conducted, research implications, limitations, and suggestions given for further research.