Responsible Investing

ESG rating methodology

2021

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ESG RATING METHODOLOGY

The ESG rating methodology contained in this document represents how the ESG analysis is performed under normal market conditions and can change without notice. This is a simplified version of the full methodology.

The EFG Asset Management (EFGAM) rating system outlined in the below article has been developed to integrate ESG criteria into our investment process and financial analysis.

We believe the integration of ESG data can improve our understanding of the companies we invest in and can potentially force some positive improvement for the society and the environment we live in. We however recognise that ESG ratings are still in their infancy and may face some issues; there is the potential for different methodologies to produce conflicting results and being presented with a black box approach may make outcomes difficult to comprehend. To best meet the needs of our clients, fulfil our due-diligence requirements and remain responsible for our judgements we built an internal approach to ESG analysis.

To reduce the subjective nature inherent in ESG factor analysis EFGAM has outlined a few important guidelines:

i. Issues must be clearly identified and prioritised according to the characteristics of the industry.

ii. The definition of criteria used to identify what is material and what is not, needs to be clear and transparent.

iii. Criteria should be flexible as different information can have a different weight for the various stakeholders.

iv. The process needs to be rigorous and replicable.

v. It should be practical and simple enough to be used and communicated.

In the process of applying these guidelines there are three key areas in which work is needed to come to an overall rating:

- ➡ Research: finding the required information;
- ➡ Developing a framework: for organising information in a coherent set of Key Performance Indicators (*KPIs*); and
- ➡ Producing a rating: which requires an assessment of which issues are material and how they should be weighted together.

Research

The search for data, while less difficult than in the past, is still not an easy task. The reporting of sustainability information is increasingly becoming common practice but there is not yet a recognised industry standard nor is it mandatory.

There are at least three big competing standards, but they are not completely aligned. These are produced by the Sustainability Accounting Standards Board (SASB), the Global Reporting Initiative (GRI) and Integrated Reporting (IR). Additionally, specific initiatives have been made by countries or stock exchanges. Table 1 shows the diversity of approaches to sustainability reporting.

Not all regulatory bodies share the same perspective on whether such reporting is needed or should be prescribed. As such, companies will need to determine the nature and extent of the sustainability information they disclose, if any, and whether to follow one of the frameworks provided by a recognised organisation.

Given the non-standard mandatory obligation to reporting, data must be extracted from CSR (Corporate Social Responsibility) reporting or some specific studies. The quality of these is difficult to judge. A 2010 report from PWC[1] looked at CSR reports issued by more than 600 companies worldwide. The report found that because companies take varying approaches to CSR reporting, even if the data are correct, it can be challenging to assess companies' actual performance, or to gauge their efforts in comparison to one another. "*Reports can be confusing because it is so different from company to company, influenced by the nature of operation, location, size and geographic reach*". Even if things improved in the last few years, the main issues described above are still relevant. For instance, a company may report Scope 1 emissions; another one Scope 2; and a third can report emissions net of carbon credits.[2]

Integrated and mandatory sustainability reports are subject to the scrutiny of regulators and investors, who are often demanding with the accuracy of ESG data, companies may

[1] PWC CSR trends 2010

[2] The GHG Protocol Corporate Standard classifies a company's GHG (greenhouse gas) emissions into three 'scopes'. Scope 1 emissions are direct emissions from owned or controlled sources. Scope 2 emissions are indirect emissions from the generation of purchased energy. Scope 3 emissions are all indirect emissions (not included in Scope 2) that occur in the value chain of the reporting company, including both upstream and downstream emissions. https://ghgprotocol.org/sites/default/files/standards_supporting/FAQ.pdf

Table 1: Difference of approach to sustainability reporting[1]

	Source of sustainability reporting initiative				Scope of application					Scope of subject matter		Disclosure model	
	Other government bodies	Securities regulators	Stock Exchange	Professional associations	All	Listed	Top 100	SOEs	Other	Social	Environmental	No. of mandatory initiatives	No. of voluntary initiatives
Argentina	M			V	M[3] V					M V	M V	2	
Australia		M	M C		M	M C				M C	M V	4	
Brazil	M M[2] V	M	M V	M V	V	M V		M	M[4,5]	M V	M V	6	5
Canada	M	M	M			M			M[5]	M	M	3	
China[8]	M V V[2]		M V		M V	M V	M	V	M[5] V[6]	M V	M V	4	5
EU	M C V				M V			M V	M[5,6] C[3,6]	M C V	M C V	5	2
France	M C V				M V			V[3]	M[3,7] V[3]	M C V	M C V	2	2
Germany	M V		V		M V	V				M V	M V	1	2
India	M V	M			V	M	M	V	M[6,7]	M V	M V	4	2
Indonesia	M C	M				M C		M		M C	M C	3	
Italy	M V			V	M V		M	V	M[6] V[4]	M V	M V	4	5
Japan	M V		V		V	V			M[5]	V	M V	2	3
Mexico	M V				M V						M V	1	1
Russia	M	M			M	M		M			M	3	
Saudi Arabia													
South Africa	M V				M V	C		M		M C	M C V	6	1
South Korea		M			V	M			M[6]	V	M V	1	2
Turkey		M				M				M	M	1	
UK	M C V		M		V	M C			M[6]	C	M C V	5	1
US	M	M				M V		M	M[5]	M	M V	4	1

Source: UNCTAD

KEY: M – Mandatory initiatives C – Mandatory comply or explain initiative V –Voluntary initiatives

[1] This table compiles information about G20 reporting initiatives implemented since the United Nations Conference on Environment and Development (UNCED), or Rio Summit in 1992. It is not a fully comprehensive list and may omit some existing or new initiatives affected by subsequent revision or legislation
[2] Initiatives implemented by a subnational government
[3] Companies with a specific number of employees
[4] Policies directed towards SMEs, or companies who have received public financial support
[5] Companies emitting a specific GHG, using a specific amount of energy, or selected due to size of company
[6] Companies in a specific industry, or specifically identified by government body
[7] Companies with a specific revenue amount
[8] Includes Hong Kong

hesitate to include it except where necessary. Refinitiv (Asset4) and Bloomberg provide some or a complete set of data. Other players also exist but these are more focused on specific aspects such as greenhouse gas (GHG) emissions, controversies or ethical aspects. To create a robust ESG methodology we decided therefore to integrate multiple sources and complement them with our own research even if the process to analyse many companies is a very long and time consuming one. We obtain data from Refinitiv4 a very complete provider of raw information.

Framework

To build the ESG analysis, information alone is not sufficient. There is the need to organise the data in a coherent and sensible way, to create a conceptual organisation of the data and a framework for analysis. Once this is done it is possible to define which are the most relevant indicators (among the many we have) to assess the sustainability of companies in different sectors.

To assess and build a framework for the ESG analysis we developed a five-step process.

i. Define the industries/sectors we want to focus on.

ii. Define a scheme and the Key Performance Indicators (*KPIs*) that broadly allow for a complete understanding of the relations between any company and its stakeholders.

iii. Define and regroup the data needed to assess the *KPIs*.

iv. Define the materiality (weight, relevance) of *KPIs* for each industry.

v. Define any additional requirement specific for each industry.

Definition of industries

To facilitate comparative assessments of *KPIs*, we need to define a classification to identify distinct industry groups of companies with similar activities and facing comparable ESG challenges and opportunities. To this respect it is quite difficult to find the right balance between complexity and simplicity. Sectors are very simple to use but are too “high level” and contain companies with many differences among them. On the other hand, moving to greater granularity increases complexity and reduces the possibility of benchmarking. We decided therefore to work at the industry group level using GICS (Global Industry Classification Standards) sector classification but recognise there are limitations to this approach as companies may have activities in different industries.

Definition of the scheme

While, at first glance, the idea of creating a scheme *ex-novo* was appealing, we decided to follow the GRI[3] classification system as it appears to be the most widespread. However, while we maintain the main *KPIs* of the GRI, we slightly changed the organisation of inputs to simplify the structure. Doing it that way we can be very rigorous, as we apply a well-defined scheme, but at the same time we can gain flexibility.

One of the additional advantages we aim for is that their framework is already somewhat established and simplifies the organisation, the finding of information and the comparability of outcomes.

GRI is a standard to report data and information and is not a tool that can be used to perform analysis.

Starting from the GRI classification we therefore slightly reshuffled the organisation of data and decided to organise the pillars in a way that, according to us, help to establish a more direct relation with the main stakeholders of a company.

➡ **Governance** (shareholder)
- *Shareholders*
- *Compensations*
- *Board structure*
- *Board functioning and controls*

➡ **Environment** (environment)
- *Natural Resources*
- *Emissions*
- *Ecosystem*

➡ **Society** (customers)
- *Products*
- *Community*

➡ **Employees and Supply Chain** (workforce)
- *Employees*
- *Supply Chain*

However, the four pillars and the 10 categories we identify are not yet sufficient for a correct analysis as a more granular approach is needed. We think a sustainability analysis framework should be well balanced and sufficiently large to be used for all the sectors and at the same time we think we need to concentrate on the most material aspect of a company/industry. These are the material ones, the ones that must be considered in the investment process to respect the fiduciary duties.[4] As we previously saw, the definition of materiality still has too wide a range of interpretation and for some investors additional information may be relevant.

Appendix 1 shows the complete GRI reporting framework scheme and in Appendix 2 how we reshuffled it.

[3] https://www.globalreporting.org/standards/gri-standards-download-center/
[4] UNEP ”*The Freshfield Report*” 2005 – UNEP, ”*Fiduciary responsibility*”, 2009

Definition and regrouping of the data to assess the *KPI*s

Before entering more into the details we provide a simple glossary:

- **Value**: is the numeric result of some data or operations. It is a kind of raw data that need further elaboration.
- **Score:** is a value that is elaborated through normalisation procedures or similar.
- **Weight:** defines the relevance of a data/*KPI* amongst others and is expressed as a percentage.
- **Data points:** a set of raw data or information that are weighted and taken together defining a *KPI*.

Once the main scheme and data collection is defined, we need to regroup all the raw data in a coherent way and transform them into numbers that can be used for the analysis and the definition of *KPIs*.

The transformation of the information obtained must be treated in two different ways according to the data; if the information is quantitative the number can be directly collected. If the information is descriptive, it must be transformed into a numeric input to be treated. Sometimes the numbers obtained by qualitative indicators can be used without further elaborations given their homogeneity but, in other cases, the numbers obtained from quantitative indicators need to be normalised on an industry basis before any treatment is possible.

For quantitative inputs, the numbers generally don't have to be based on "absolute" data (for example the absolute level of energy consumption), but mainly on data that are standardised relative to the size of the output. For instance, total energy consumption can be divided by produced units or production value, corresponding to the energy intensity.

In the second case, for qualitative information, the data should be treated differently and must be transformed into a series of Yes/No/ N/A questions a numeric value and a "direction" which can be attributed as a yes answer can be positive for some questions and negative for others. As is easily understandable, the number of questions that can be raised is wide and only the availability of resources (or data) can suggest how deep one can go.

This exercise, even if done with the most rigorous approach is subject to a range of interpretation and subjectivity. To reduce this aspect we define a simple criterion: in case of multiple or subsequent questions, we separate them and consider them as separated data points that are used to define the relevant *KPI*.

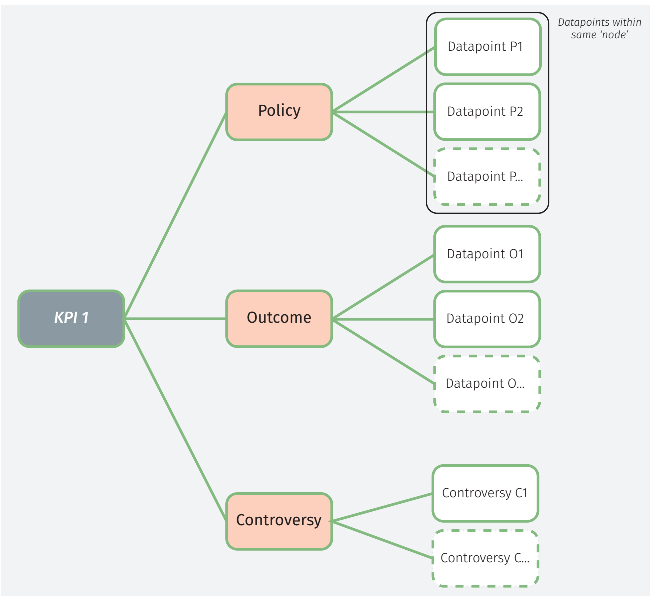
Using that method, every single indicator of a company can have a numeric value and can be compared with other companies.

For each *KPI* we also decided, whenever possible, to separate the answers linked to policies from the one linked to data (outcome) or from the ones linked to controversies. The idea allows for a better separation between the effective behaviour and the "declarations of intent" allowing us to better understand if companies "walk the talk". We decided therefore to differently weight policies, outcomes and controversies, giving more weight to "real life" events.

Once all the information is transformed into a numeric input, we need to define the weights of the different data points as often a *KPI* is obtained by the analysis of more than one of them.

We consulted existing literature on the subject, internally interviewed people with specific knowledge from the CEO office, regulators, compliance officers, human resources specialists or sector analysts, and with their inputs we defined a Likert scale[5] for each of the datapoints and rebased to 100% to obtain a final *KPI* score.

Figure 1



[5] The most widely-used approach to scaling responses in survey data

Materiality and the weighting of *KPIs*

Understanding the materiality of ESG issues and how materiality changes with respect to particular industries is critical for a successful implementation of a correct analysis; we need to define how to weight the different *KPI* to reach a unique and synthetic score able to sum-up the profile of a company.

We think that an ESG analysis should concentrate only on a few *KPIs* and skip less relevant indicators as suggested by Harvard analysis.[6] To prepare, we measured real data from Refinitiv's database.

We obtained the quantitative hard data for all the companies under coverage (more than 6000) and aggregated them according to the tree presented in Appendix 2. Of course, not all the *KPI* could be filled. Industry by industry segmentation allows us to have a clear understanding of the exposure of every industry to factors such as energy consumption, waste, use of natural resources, GHG emissions, litigations, accident and lost hours at work, controversies with Society etc.

We additionally went through the main publications and for every industry looked at the aspects that are considered material to report. Among the most useful are the SD-*KPI* Standard 2010-2014 developed by Dr. A.Hesse[7] and the following 2016 – 2021 revision developed on behalf of the German Federal Environmental Ministry. These documents sum-up the main *KPIs* for the ESG analysis. The results are not always aligned among them and terminology is somewhat different, as can be seen in Table 2, but they provide an alternative useful indication on what to consider or a confirmation of the data previously obtained.

For the next step, to finally assess the weight of each *KPI* for all industries, we adapted a materiality test derived from existing sources, specifically from AccountAbility[8] and Harvard.[9] Our major substantive revision to such a definition is that we reduced the number of sustainability drivers for the sake of simplification and easy communication:

Table 2 – Emission *KPI* for Energy Equipment & Services according to SD-*KPI* standard

	Abbreviations	Definitions
KPI 1 Credit Agricole Cheuveux	Climate change	What is the company's policy for addressing global warming? How does the company comply and react to EU ETS constraints and to targets under the revised Fuel Quality Directive which requires fuel suppliers to cut their total CO2 emissions by 10% by 2020? – CSS projects? – Renewable energy investments?
KPI 3 Dexia	GHG intensity of operations	GHG emissions (Scope 1 and 2) in tCO2e/million hours worked
KPI 2 Dexia	Exposure to renewable energies	Share of revenues/earnings (%) derived from services/equipment used for the production of renewable energies
KPI 3 KLD	Climate change	Performance trends/management systems
KPI 2 Social Investment Forum Japan	CO2 emission	CO2 emission from drilling
KPI 1 RiskMetrics	S1 – GHG	Scope I – Direct GHG emissions
KPI 2 RiskMetrics	S3 – GHG	Scope III – Indirect GHG emissions from products
KPI Sarasin	GHG efficiency of production	Direct and indirect CO2-equivalent emissions (in tonnes per sales unit)
KPI 1 Sustainalytics	Environmental Programs	Programs and targets to address key environmental impacts (especially hazardous waste, water use and air emissions)
KPI 2 Sustainalytics	Environmental Impact of Operations	Reporting on direct environmental impact, including total weight and kind of hazardous waste generates, total emissions to air, water and landfill
KPI 2 vigeo	Greenhouse gas (GHG) emissions	Amounts of scope 1 and scope 2 emissions related to operations (fleet, construction sites, fabrication, offshore), normalised to turnover (ktCO2EQ/ M €)

[7] SD-*KPI* Standard 2010-2014, Dr.A.Hesse
[8] AccountAbility; *The Materiality Report*, 2006
[9] IRI-Harvard University, *From Transparency to Performance*, 2010

We think that there are four broad drivers of sustainability:

- **Financial impact**
  We consider here the possible financial impact the *KPI* has on the performance of the average company.

- **Regulatory**
  In this driver we consider either the legal changes that can or will be forced by regulators or the peer-based norms that industry bodies or practice can define.

- **Society and stakeholder pressure**
  With this driver we want to consider the pressure coming from Society or stakeholders in terms of products and behaviours.

- **Competitive advantage**
  This latter driver reflects the possibility to create a competitive advantage through innovation and opening up of new business opportunities.

These four drivers have a different weight. As a starting point, we estimate that financial and regulatory drivers have a stronger relevance than stakeholder pressure or competitive advantage. The latter is additionally very difficult to evaluate and therefore we don't want to attribute too much weight to this driver.

However, for some sectors, i.e. the ones more exposed to consumers, the pressure from society or stakeholders assume a greater importance than for industries are less exposed to public scrutiny such as mining or industrial agglomerates. These standard weights can therefore be modified to consider the specificity of each industry.

We apply similar method to the one suggested by the Harvard publication even if we decided to be guided by a mathematical rule that allows us to consider only the main *KPIs* and discard the ones that appear not to be material. With our approach we end up taking into account fewer *KPIs* for sectors where the materiality is more concentrated and more *KPIs* when its materiality is more widespread and it is more difficult to establish a ranking among the main indicators.

Having selected the *KPIs* we can transform their value in weight simply summing up the values and transform each of them to a percentage.

The final ESG score will then be a number obtained multiplying the score of the normalised *KPIs* with their percentage weights. The ESG score will be a number comprised between 0% and 100% even if both limits are almost impossible to reach ESG ratings cannot fully represent the complexity of a company and its interaction with the broad set of stakeholders, but they represent a synthetic indicator useful to highlight potential hidden risks.

The "production" of an ESG rating is the start to potential discussions and engagement activities with invested companies to promote better and less risky behaviours. It is also worth mentioning that the obtained ESG score is comparable and can only be used among the companies in the same industry; a company with a lower ESG score in industry A is not necessarily less sustainable than a company with a higher score in industry B. Every industry is exposed to different risks and issues and it is not our task to create a system of moral judgement. Our work is to try to detect, in every industry and sector, which are the companies that face less risk or are better prepared to face future challenges.

There may be occasions in which a fund's shares may not be voted in strict adherence to these Guidelines. These decisions will always be based on our review of the merits of the proposal and will consider relevant information and company-specific circumstances.

Our policy is subject to change without notice.

Appendix 1 – GRI reporting scheme

G	**General**	S	**Social**
G1	Strategy And Analysis	SL	Labour Practices And Decent Work
G2	Organisational Profile	SL1	Employment
G3	Identified Material Aspects And Boundaries	SL2	Labour Management Relations
G4	Stakeholder Engagement	SL3	Occupational Health And Safety
G5	Report Profile	SL4	Training And Education
G6	Governance	SL5	Diversity And Equal Opportunity
G7	Ethics And Integrity	SL6	Equal Remuneration
G8	Disclosures On Management Approach	SL7	Supplier Assessment
E	**Environment**	SL8	Labour Practices
E1	Materials	SL9	Labour Practices Grievance Mechanism
E2	Energy	SHR	**Human Rights**
E3	WaterK	SHR1	Investment
E4	Biodiversity	SHR2	Non Discrimination
E5	Emissions	SHR3	Freedom Of Association
E6	Effluent And Waste	SHR4	Child Labour
E7	Product And Services	SHR5	Forced Labour
E8	Compliance	SHR6	Security
E9	Transport	SHR7	Indigenous People
E10	Overall	SHR8	Assessment
E11	Supplier Environmental Assessment	SHR9	Supplier Human Right
E12	Environmental Grievance Mechanism	SHR10	Hr Grievance Mechanism
SC	**Society**	SP	**Product Responsibility**
SC1	Local Communities	SP1	Customer Health And Safety
SC2	Anti-Corruption	SP2	Product And Service Labeling
SC3	Public Policy	SP3	Marketing
SC4	Anti-Competitive Behaviour	SP4	Customer Privacy
SC5	Compliance	SP5	Compliance
SC6	Supplier Assessment For Impact On Society		
SC7	Grievance Mechanism		

Appendix 2 – ESG analysis tree

Governance (shareholder)	**Shareholders**	Strategy and analysis	
		Disclosures on management approach	
		Stakeholder engagement	
	Board functioning	Compensation policy	
		Board structure	
		Board functioning	

Environment (environment)	**Natural resources**	Materials	
		Energy	
		Water	
	Emissions	Emissions	
		Effluent and waste	
	Ecosystem	Ecosystem	Biodiversity
			Transport
			Overall
			Environmental compliance
			Environmental grievance mechanism

Society (customers)	**Products**	Product safety	Customer health and safety
			Product and service labelling
			Marketing
		Product responsibility	Customer privacy
			Compliance
		Production innovation	Product and services
	Community	Community Impact	Local communities
			Public policy
		Human rights	Child labour
			Indigenous people
		Business ethic	Anti-corruption
			Anti-competitive behaviour
			Compliance
			Ethics and integrity

Employees and supply chain (workforce)	**Employees**	Training and education	Training and education
			Investment
		Diversity and opportunities	Diversity and opportunity
			Equal remuneration
			Non discrimination
		Health and safety	Occupational health and safety
			Labour practices grievance mechanism
			Security
		Employment quality	Employment
			Labour management relations
			Labour practices
		Employment rights	Freedom of association
			Forced labour
			HR assessment
			HR grievance mechanism
	Supply chain	SC social condition	Supplier assessment for impact on society
			Supplier human right
			Supplier assessment
		SC environment	Grievance mechanism
			Supplier environmental assessment

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