Responsible Investing

Sovereign rating methodology

2021

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HIGHLIGHTED IN THIS PUBLICATION:

- GLOBAL STRATEGIC ASSET ALLOCATION
- GLOBAL SECURITY SELECTION
- REGIONAL ASSET ALLOCATION
- REGIONAL PORTFOLIO CONSTRUCTION

SOVEREIGN RATING METHODOLOGY

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

The purpose of ESG rating is to analyse ESG risks that are ordinarily not taken into account by normal sovereign ratings. This can be used as a supplementary and integrative element in the correct assessment of country risk.

Research methodology

We use a risk-based approach in our methodology which assesses the ESG risks to which countries are exposed, based on their natural resources and their social and governance structure.

As proposed by MSCI in their rating model, ESG risks can be seen as composed of two elements:

- Risk exposure (e.g. the availability of water resources;
- Risk management (e.g. the management of available water resources).

Framework

In order to build an effective ESG rating model, information alone is not sufficient: it must be organised in a coherent way to allow comparisons.

In order to do this, we use a four- step model:

i. Define a *KPI* scheme that covers all the possible ESG risks on a country level;

ii. Select available data sources needed to assess the value of each *KPI*;

iii. Weight each *KPI* based on their materiality;

iv. Assign an ESG Country rating based on the overall score.

Definition of the Scheme

In order to compare the different levels of ESG country risk, we have to create a classification of *KPI*s that are able to summarise all the possible ESG issues faced on a country level.

To do so, we researched available ESG country risk classifications, both academic works and from practitioners' works. After comparing different approaches and *KPI*s, we grouped them in order to create a final scheme of *KPI*s.

The scheme that we propose is shown in Figure 1.

As we can see, within the ESG dimensions, we identified five risks categories that comprise 26 risk factors.

1. Three ESG dimensions, five risk categories and 26 factors

Dimensions	Risk Categories	Risk Factors
ENVIRONMENT	Natural Disasters	Earthquakes
		Cyclones
		Floods
		Droughts
		Sea level rise
	Natural Resources	Cropland
		Forest land
		Fishing grounds
		Grazing land
		Built-up land
		Carbon Footprint
		Biodiversity
		Nuclear energy
		Water
SOCIAL	Social Unrest	Life Expectancy
		Education
		Income Disparity
		Age Inequality
	Competitiveness	Ease of Doing Business
		Innovation
GOVERNANCE	Governance	Voice and Accountability
		Political Stability and Absence of Violence
		Government Effectiveness
		Regulatory Quality
		Rule of Law
		Control of Corruption

Data Selection

In the selection of data, we prioritised indices that took into account risk exposure and risk management.

We identified 11 suitable data sources:

- World Risk Index;
- ND-GAIN Index;
- Ecological Footprint;
- Benefits Index for Biodiversity;
- Electricity Production from Nuclear Sources;
- Freshwater Resources/ Water Consumption;
- Human Development Index;
- Age Dependency Ratio;
- Ease of Doing Business;
- Global Innovation Index;
- Worldwide Governance Indicators.

Materiality Assessment

The materiality of each *KPI* was defined by:

- taking into consideration existing assessments from practitioners;
- the link between country future un-captured risk and ESG factors.

By combining these two methods we were able to come up with a final materiality assessment.

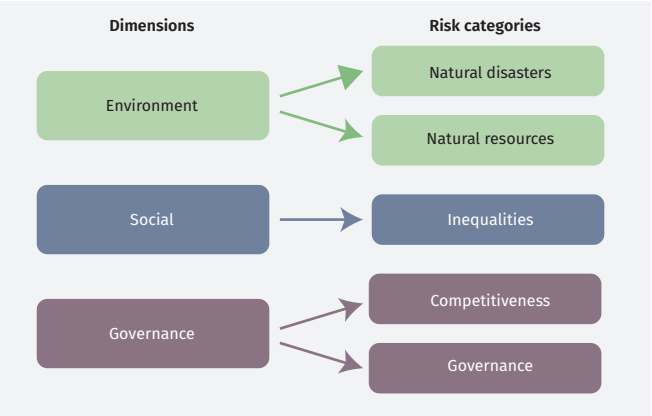
In particular, we initially used the first method on an ESG dimension level, in order to understand which of the dimensions were generally considered more material, while the second method was used to assess the weights of each risk category.

On a dimension level, we found that governance is generally considered as the most material, while the social and environment dimensions were considered almost at the same degree of materiality.

To better consider risks that are not captured by existing risk models we decided to reduce the focus and weight assigned to governance as this is already captured by many external data and ratings. At the same time environmental and social aspects are still under-appreciated and we think will progressively become more relevant.

The scheme is shown in Figure 2.

2. Dimensions and Risk categories



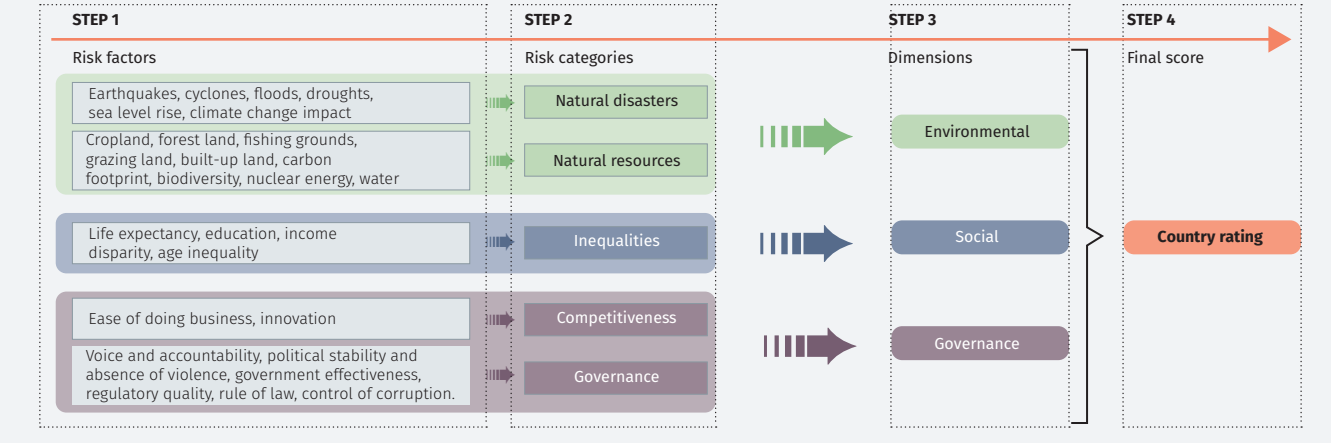
Definition of the ESG Country Risk

The ESG rating of the country is then defined normalizing the data sources and applying to the normalized results the weights established during the materiality assessment. The final score is therefore a number from 0% to 100% where the weakest countries receive a lower score.

An additional ranking is then performed to consider the different ESG "maturity" of developed countries against emerging ones that are often weaker particularly on social and governance KPIs. Sovereing issuers receive therefore both an absolute rating and a relative one that consider their belonging to emerging or developed countries according to OECD definition.

Figure 3 shows the structure of our ESG rating model and the various steps for the calculation of the final ESG country rating.

3. Structure of the country sustainability framework



Environmental Dimension

Within the Environment category we identified two risks categories. These are:

i. Natural disasters risk;
ii. Natural resources risk.

Natural Disasters Risk

We define as natural disasters risks the possibility that natural events have an impact on countries' economies.

This risk category comprises the following:

- Earthquakes;
- Cyclones;
- Floods;
- Droughts;
- Sea level rise;
- Climate change impact.

In order to assess this kind of risk we used a combination of the World Risk Index and the Notre Dame Global Adaptation Country Index (ND-GAIN) as the main data sources.

World Risk Index

The World Risk Index[1] developed and calculated by Prof. Birkmann and Dr. Welle from the University of Stuttgart, evaluates the exposure to natural hazards faced by 171 countries and assesses the inherent county vulnerability.

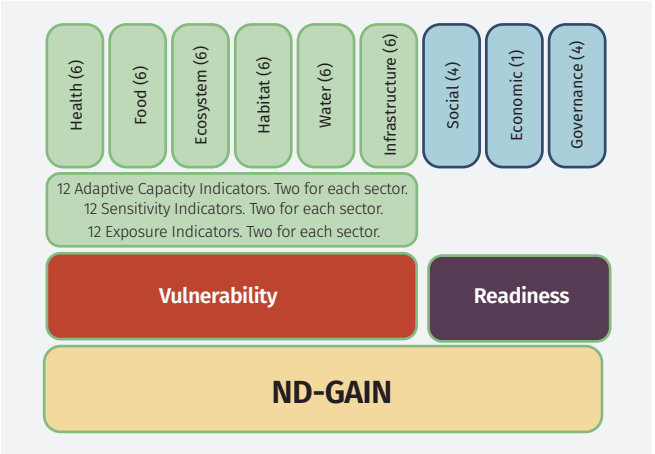
Figure 5 overleaf is an illustration that briefly explains the calculation methodology of the index: Natural resource risks

Notre Dame Global Adaptation Country Index

The ND-GAIN Country Index[2] is developed and maintained by the Notre Dame University in Washington. Similarly to the World Risk Index it uses 45 indicators and over 20 years of data to summarize the vulnerability and readiness of nations to react to the global challenges brought by climate disruption.

To better gauge the exposure to the climate threat ND-GAIN analyses food, water, health, ecosystem services, human habitat and infrastructure, while considers economic, governance and social readiness to evaluate the adaptation capabilities. Figure 4 summarizes the ND GAIN approach:

4. Notre Dame Global Adaptation Country Index



[1] http://www.uni-stuttgart.de/ireus/Internationales/WorldRiskIndex/
[2] https://gain.nd.edu/our-work/country-index/

5. World Risk Index Methodology[2]

Natural hazard sphere		Vulnerability – Societal sphere		
Exposure	X	Susceptibility	Coping capacity	Adaptive capacity
Exposure to natural hazards		Likelihood of suffering harm	Capacities to reduce negative consequences	Capacities for long-term strategies for societal change

1. Exposure	2. Susceptibility	3. Coping capacity	4. Adaptive capacity
EXPOSED POPULATION WITH REGARD TO: A) Earthquakes B) Cyclones C) Floods D) Droughts E) Sea-level rise	**PUBLIC INFRASTRUCTURE** A) Population without access to improved sanitation B) Population without access to clean water **HOUSING CONDITIONS** Proportion of population in slums; proportion of semi-solid and fragile houses → Limited data availability **NUTRITION** C) Percentage of undernourished population **POVERTY AND DEPENDENCIES** D) Dependency ratio (proportion of under 15 and over 65-year olds in relation to the working population) E) Extreme poverty (population living on less than 1.25 USD (live PPPs) per day) **ECONOMIC CAPACITY AND INCOME** F) Gross domestic product per capita (Purchasing Power Parity) G) Gini-Index	**GOVERNMENT AND AUTHORITIES** A) Corruption Perception Index B) Failed States Index **DISASTER PREPAREDNESS AND EARLY WARNING** National disaster risk management policy according **MEDICAL SERICES** C) Number of physicians per 10,000 population D) Number of hospital beds per 10,000 population **SOCIAL NETWORKS** **NEIGHBOURHOOD, FAMILY AND SELF-HELP** **ECONOMIC COVERAGE** E) Insurance (except life insurance)	**EDUCATION AND RESEARCH** A) Adult literacy rate B) Combined gross school enrolment (rate of school-aged children in primary, secondary and tertiary educational institutions) **GENDER EQUALITY** C) Gender parity in education (in primary, secondary and tertiary educational institutions) D) Percentage of female representatives in the National Parliament **ENVIRONMENTAL STATUS / ECOSYSTEM PROTECTION** E) Water resources F) Protection of biodiversity and habitats G) Forest management H) Agricultural management **ADAPTATION STRATEGIES** Volume of National Adaptation Programmes of Action to Climate Change, Climate Change Convention (available for 45 of the least developed countries) **INVESTMENT** I) Life expectancy at birth J) Private health expenditure K) Public health expenditure

Natural Resources Risks

We define natural resource risk as the risk associated with the use of natural resources. In this category we include the following risk factors:

- Cropland overuse;
- Forest land overuse;
- Fishing grounds overuse;
- Grazing land overuse;
- Built-up land overuse;
- Water overuse;
- Carbon footprint;
- Biodiversity loss;
- Nuclear energy.

In order to assess this kind of risk we used the following data sources:

- ➡ Ecological Footprint;
- ➡ Benefits Index for Biodiversity;
- ➡ Electricity Production from Nuclear Sources;
- ➡ Water Footprint;
- ➡ Renewable Internal Freshwater Resources.

[2] Bioproductivity is the amount of biological productivity required to renew the biological resources humans use (food, timber etc) and to absorb their waste.

Ecological Footprint

The Ecological Footprint is an index produced by the Global Footprint Network. It measures the area of land and water it takes for a human population to generate the renewable resources it consumes and to absorb the corresponding waste it generates, using prevailing technology. In other words, it measures the "quantity of nature" that we use and compares it with how much "nature" we have.

The components of the index include:

- **Cropland**
  Cropland is the most bioproductive[1] of all the land-use types and consists of areas used to produce food and fibre for human consumption, feed for livestock, oil crops, and rubber. The cropland footprint includes crop products allocated to livestock and aquaculture feed mixes, and those used for fibres and materials. Due to lack of globally consistent data sets, current cropland footprint calculations do not yet take into account the extent to which farming techniques or unsustainable agricultural practices may cause long-term degradation of soil.

- **Forest land**
  Forest land provides for two competing services: firstly, the forest product footprint, which is calculated based on the amount of lumber, pulp, timber products and fuel wood consumed by a population on a yearly basis, and secondly the carbon footprint, which represents the carbon dioxide emissions from burning fossil fuels in addition to the embodied carbon in imported goods. The carbon footprint component is represented by the area of forest land required to sequester these carbon emissions. Currently, the carbon footprint is the largest portion of humanity's footprint.

- **Fishing grounds**
  The fishing grounds footprint is calculated based on estimates of the maximum sustainable catch for a variety of fish species. These sustainable catch estimates are converted into an equivalent mass of primary production based on the various species' trophic levels. This estimate of maximum harvestable primary production is then divided amongst the continental shelf areas of the world. Fish caught and used in aquaculture feed mixes are included.

6. Ecological Footprint Index methodology[3]

Ecological Footprint of Consumption	Ecological Footprint of Production	Net Ecological Footprint of Trade
The Ecological Footprint of Consumption indicates the consumption of bio-capacity by a country's inhabitants. In order to assess the total domestic demand for resources and ecological services of a population, we use the Ecological Footprint of Consumption (EFC). EFC accounts for both the export of national resources and ecological services for use in other countries, and the import of resources and ecological services for domestic consumption. EFC is most amenable to change by individuals through changes in their consumption behaviour.	The Ecological Footprint of Production indicates the consumption of bio-capacity resulting from production processes within a given geographic area, such as a country or region. It is the sum of all the bio-productive areas within a country necessary for supporting the actual harvest of primary products (cropland, grazing land, forestland and fishing grounds), the country's built-up area (roads, factories, cities), and the area needed to absorb all fossil fuel carbon emissions generated within the country. This measure mirrors the gross domestic product which represents the sum of the values of all goods and services produced within a country's borders.	The Ecological Footprint of Imports and Exports indicates the use of bio-capacity within international trade. Embedded in trade between countries is a use of bio-capacity, the net Ecological Footprint of Imports minus the Ecological Footprint of Exports). If the Ecological Footprint embodied in exports is higher than that of imports, then a country is a net exporter of renewable resources and ecological services. Conversely a country whose Footprint of Imports is higher than that embodied in Exports depends on the renewable resources and ecological services generated by ecological assets from outside its geographical boundaries.

[3] http://www.footprintnetwork.org/resources/data/

- **Grazing land**
  Grazing land is used to raise livestock for meat, dairy, hide, and wool products. The grazing land footprint is calculated by comparing the amount of livestock feed available in a country with the amount of feed required for all livestock in that year, with the remainder of feed demand assumed to come from grazing land.

- **Built-up land**
  The built-up land footprint is calculated based on the area of land covered by human infrastructure: transportation, housing, and industrial structures. Built-up land may occupy what would previously have been cropland.

Figure 6 shows the steps for the calculation of the ecological footprint index.

The ecological footprint is one of the most complete indices available. Indeed, it takes into consideration many of the risks related to the area of natural resources. That is why it isn't surprising that we found that this index was utilised in almost all other methodologies that we analysed.

Benefit Index for Biodiversity

The Benefits Index for Biodiversity is a composite index of relative biodiversity potential for each country based on the species represented in each country, their threat status, and the diversity of habitat types in each country. This is developed by Global Environment Facility (GEF), an organisation that unites 183 countries in partnership with international institutions, civil society organisations (CSOs), and the private sector to address global environmental issues while supporting national sustainable development initiatives.

This is one of the few statistics about biodiversity that takes into consideration both the aspects of biodiversity potential and threat status. This statistic measures the potential benefit from biodiversity, meaning that countries with higher scores have also a higher potential for benefits.

Electricity Production from Nuclear Sources

This index is calculated by the World Bank and it measures the level of nuclear energy production by country.

Water Footprint and Renewable Internal Freshwater Resources

Differently from the other cases previously mentioned, for water resources risk we used two different indicators. This is because it was not possible to identify an index that considered both the aspect of availability of water resources and the management of water resources.

The two indices that we selected were:

- Water Footprint;
- Renewable Internal Freshwater Resources.

On one hand, the water footprint is an index produced by the Water Footprint Network that measures the amount of water used to produce each of the goods and services we use. It can be measured for a single process, such as growing rice, for a product, such as a pair of jeans, for the fuel we put in our car, or for an entire multi-national company. The water footprint can also tell us how much water is being consumed by a particular country.

We can see a brief explanation of the three types of water footprints analysed by this indicator.

The three water footprints:[4]

i. **Green water footprint**: water from precipitation that is stored in roots within the soil and evaporated, transpired or incorporated by plants. It is particularly relevant for agricultural, horticultural and forestry products.

ii. **Blue water footprint**: water that has been sourced from surface or groundwater resources and is either evaporated, incorporated into a product or taken from one body of water and returned to another, or returned at a different time. Irrigated agriculture, industry and domestic water use can each have a blue water footprint.

iii. **Grey water footprint**: the amount of fresh water required to assimilate pollutants to meet specific water quality standards. The grey water footprint considers point-source pollution discharged to a freshwater resource directly through a pipe or indirectly through runoff or leaching from the soil, impervious surfaces, or other diffuse sources.

On the other hand, Renewable Internal Freshwater Resources index is produced by the World Bank and it measures the actual level of available water resources within a country.

[4] Source: http://waterfootprint.org/en/water-footprint/what-is-water-footprint/

Social Dimension

Within the Social category, we identified one type of ESG risk and this is related to social unrest.

Social Unrest Risk

We define the likelihood of political instability due to social inequalities, such as income disparity, education, age and life expectancy as inequality risk.

The main sources of data for this risk category are:

- Human Development Index;
- Age Dependency Ratio.
- Social Progress Index

Human Development Index (HDI)

The Human Development Index (HDI) is a composite statistic of life expectancy, education, and per capita income indicators, which are used to rank countries into four tiers of human development. A country scores higher in the HDI when the lifespan is higher, the education level is higher, and the GDP per capita is higher. The HDI was developed by Indian economist Amartya Sen and Pakistani economist Mahbub ul Haq, and is often framed in terms of whether people are able to "be" and "do" desirable things in their life. It was published by the United Nations Development Programme (UNDP). Figure 7 below briefly explains HDI methodology.

We selected this index because in its calculations the HDI takes into account three out of four of the risk factors that we identified as being indicators of the inequality risk. These are:

1. Life Expectancy;
2. Income Distribution (GNI Index);
3. Education.

Age Dependency Ratio

This index is produced by the World Bank and it gives an insight into the number of people of non-working age compared to the number of those of working age, estimating the percentage of the total working population per each country. It is calculated by considering the ratio of dependents (people younger than 15 or older than 64) to the working age population (those aging from 15 to 64).

Social Progress Index

The Social Progress Index (SPI) is based on the writings of Amartya Sen, Douglass North, and Joseph Stiglitz and measures the well-being of citizens according to three dimensions:

- Basic Human Needs
- Foundations of well-being
- Available opportunities.

Similar to the HDI the SPI provides an additional angle to assess the social advancement of Countries.

7. Human Development Index (HDI) Methodology[4]

Dimensions	Long and healthy life	Knowledge		A decent standard of living
Indicators	Life expectancy at birth	Mean years of schooling	Expected years of schooling	GNI per capita (PPP $)
	↓	↓		↓
Dimension Index	Life expectancy index	Education index		GNI index
	↘	↓		↙
	Human Development Index			

Governance Dimension

Within the Governance category, we identified two types of risk categories and these are:

1. Risks related to competitiveness;
2. Governance risks.

Competitiveness

We define competitiveness risk as the risk on the national economy associated with a lack of country competitiveness on the international market.

Within this category we identified two risk factors. These are:

- Ease of doing business;
- Innovation.

In order to assess these risks we used two data sources:

- Ease of Doing Business Index;
- Global Innovation Index.

Ease of Doing Business Index

The Ease of Doing Business index is created by the World Bank Group. A higher ranking in this index indicates a better regulation for business and stronger protection of property rights.

Global Innovation Index

The Global Innovation Index (GII) is an annual ranking of countries by their capacity for, and success in, innovation. It is published by Cornell University, INSEAD, and the World Intellectual Property Organization, in partnership with other organisations and institutions, and is based on both subjective and objective data derived from several sources, including the International Telecommunication Union, the World Bank and the World Economic Forum. The GII is commonly used by corporate and government officials to compare countries by their level of innovation.

Governance Risk

For governance we use the definition given by the World Bank. This is defined as the traditions and institutions by which authority in a country is exercised. This includes:

- The process, by which governments are selected, monitored and replaced;
- The capacity of the government to effectively formulate and implement sound policies;
- The respect of citizens and the state for the institutions that govern economic and social interactions among them.

The World Bank itself identifies six risk factors within this category. These are:

- Voice and Accountability;
- Political Stability and Absence of Violence;
- Government Effectiveness;
- Regulatory Quality;
- Rule of Law;
- Control of Corruption.

The main data sources for these risk factors are the Worldwide Governance Indicators (WGI).

The Worldwide Governance Indicators

The World Governance Indicators, produced by the World Bank, take into consideration all six dimensions of the governance risk. This index aggregates governance indicators for over 200 countries and territories over the period 1996–2016. These indicators are based on close to 40 data sources produced by over 30 organisations worldwide and are updated annually since 2002.

Conclusions

ESG country ratings, as described here, provide an additional rich dimension to standard sovereign ratings. At EFGAM we use them as a supplementary and integrative element in our sovereign risk assessment.

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

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