Improving ESG Ratings Performance

A Stepwise Guideline for Issuers and Investors

Vers. 3, Copenhagen, Oct. 2019

Overview

1. Introduction (1)

This guideline summarizes a series of discussions facilitated by CSR LINK throughout 2019, focusing on improving ESG Ratings performance. In the discussions, Issuers as well as Investors, advisors, engagement agencies and Ratings Agencies (Chapter 4: Process) participated.

During the process, Issuer's and Investors' attitudes to ESG ratings were observed not only in relation to Rating Agencies, but also internally within their organizations, As a result, an improvement potential was identified in their general approach to ESG ratings (Chapter 5: Observations). Building on the observations and the potential for improvement, a simple approach has been outlined that provides an overall systemic view of the **Issuer-Rating Agency-Investor** interaction (Chapter 6: A simple approach). It is on this basis that the Guide's recommendations have been prepared (Chapter 7).

Recommendations follow the Deming Principle of Plan – Do – Check – Act (PDCA). These encompass an integrated approach to an organization's structure, its management and commercial purpose, and the prioritization of ESG performance and impact. This approach also articulates the need for a broad portfolio of skills.

The recommendations are independent of a rules-based or a principles-based approach, and consistent with the larger family of ESG reporting frameworks: GRI, SASB, Integrated Reporting, UNGC, SDGs, AccountAbility etc, and form a supportive basis for further TCFD considerations.

1. Introduction (2)

Glenn Frommer, the Managing Partner of ESG Matters IVS, provided his knowledge and competency as CEO and Investment Adviser and the discussions were facilitated by Jens Prebensen, the Founding Partner of CSR LINK. Neither the process nor the present guideline has been funded and is independent of any interest whether it be commercial, political or the like.

Supporting material, presentations and a full list of references can be found on the CSR LINK website (http://www.strategisk-csr.dk/).

CSR LINK would like to thank the following organizations for their support, hosting and participation in the process.

2. Scope

The goal of this Guide is to provide Issuers and Investors with a tool for improving internal dialogue on how the approach to ESG ratings can be optimized. We focus on reducing risks on the negative side and providing more benefits in the form of more investments for higher returns. Where other ESG frameworks focus on the data that issuers must provide, this Guide has a two-sided focus..

For **Issuers**, this is first and foremost about how the internal dialogue can be promoted, but also about how the dialogue with the Rating Agency can ensure that correct data is included in the rating and that the data is used correctly and supplemented with data for filling potential gaps in a true and fair way. manner. The ESG **Investors** are in a mirrored situation. For them, it's about the ratings they use not misleading investments going against their customers' expectations of ethically responsible and long-term investments, while not compromising returns for the here and now. For both sides, it is crucial to their goals that the ESG is rooted in the organization so that all relevant functions prioritize it and then act.

The recommendations concluded herein are independent of a rules-based or a principles-based approach, and consistent with the larger family of ESG reporting frameworks: GRI, SASB, Integrated Reporting, UNGC, SDGs, AccountAbility etc, and form a supportive basis for further TCFD considerations.

The recommendations can be taken individually or used to build a platform for continual Ratings improvement. Our intention is to highlight best practices and the distinctions in governance, data and communications between Issuers and Investors.

3. Background

As the climate and sustainability agenda emerges, ESG Ratings are gaining importance for investors 'choice of investment objects and issuers' prioritization of their own resources to match the demand for climate-friendly and sustainable products and services.

ESG data is becoming increasingly necessary to understand corporate purpose, strategy and management quality. Ratings agencies are critically involved in using this data to reward business performance and encourage responsible investment. With the advent of Artificial Intelligence techniques for automatically assessing and manipulating data, Issuers and Investors must master ESG governance, data and communications to improve their ESG Ratings respectively to secure the best possible return based on the ratings.

Nevertheless, both sides needs greater knowledge about how ESG ratings work: what data is included, what weight is added to the individual parameters, how overall Ratings are calculated and not least, what interaction there is between the reported data and the data sourced from independent Issuers. There is a clear economic potential in gaining and managing this knowledge. It is on this basis that CSR LINK has facilitated this process and provided this Guide.

4. Process

Four workshops sessions were held in Denmark in March – April 2019 with specialist invited input on the following issues:

- Getting the data right
- Optimizing the data
- Engagement, and
- Investment efficacy.

Amongst others the following organizations were present during the sessions: Kirkbi, Orsted, Nykredit, Sustainalytics, MP Pension, LD Fonde, Kommunekredit, Vækstfonden, Maersk, Capital Market Partners, Hermes Investment Management, Royal Bank of Canada Global Asset Management

On basis of the discussions during the sessions a preliminary draft guideline was prepared and circulated to participants and collaborating organizations prior to meetings in the UK, June 2019.

The draft was subsequently shared for road testing with the hosts for UK meetings: SustainAbility, Future Fit, MSCI, Royal Bank of Canada Global Asset Management, SustainAlytics, FTSE Russell, and Hermes Investment Management.

Views and comments were collected during the process and included in the present guideline drafts.

5. Observations (1)

Backward-looking and forecasts

Overall, though an understanding of ESG data and resulting ESG Ratings have much in common between Issuers and Investors, there are important general differences:

- An Issuer provides backwards-looking data to track reputational issues through their ESG Ratings performance.
- Investors forecast their future financial performance based on mitigating perceived risks through their portfolio's ESG Ratings performance.

New data setting

With the advent of Artificial Intelligence techniques for automatically assessing and manipulating data, Issuers and Investors must master ESG governance, data and communications to improve their ESG Ratings and respectively their return on Responsible Investments.

5. Observations (2)

Top management's prioritization

Particularly with Issuers, there seems to be less focus by top management on ESG Rating and reporting. This is also the case in companies where CSR is a high priority. Similarly, it seems that the ESG Rating is not a high priority for Investors, despite the fact that the rating must be considered a key component for the impact on the dividend. Overall, there is therefore a need for both sides to strengthen their activities around the ESG Rating to achieve a better rating and respectively returns.

Risk reduction and opportunity optimization

Despite the fact that ESG Ratings can have a significant impact on the investment flow from Investors to Issuers, few appear to have the necessary insight into effectively managing their ESG ratings. Not only does this appear as a low priority in the organization, it results in inadequate communication, and, moreover, supresses an effective reduction of risks and optimization of opportunities.

5. Observations (3)

Reporting burden for Issuers

Contrary to what may be presumed by many, data is not free and may represent a significant cost. Therefore the extent that an issuer matches the ESG Ratings and which surveys are prioritized is particularly relevant. Still, much of the organizational deficit of Issuers is indicative of internal communication about the individual ratings, the data quality and the data disclosure. Furthermore, to the extent that the company does CSR reporting, may constitute an obstacle to the prioritization of the response to ESG Rating Surveys.

Investor Priority of Rating Agency

Apparently, Investors' preferred choice of Rating Agency, Sustainalytics and MSCI, are frequently supplemented by another wild card agency. However, since the insight into Rating Agency's methodologies and scopes is not fully comprehensive, it should be assumed that the choice of agencies is not, as a rule, made on a qualified basis, but rather on the basis of marketing, and who is the majority's preferred choice. It is therefore questionable whether the choice is made on the basis of a match with its own purposes and priorities, just as it is presumed that only additional data is rarely requested where the rating is not a match.

5. Observations (4)

Mutual Insight - the Mirror

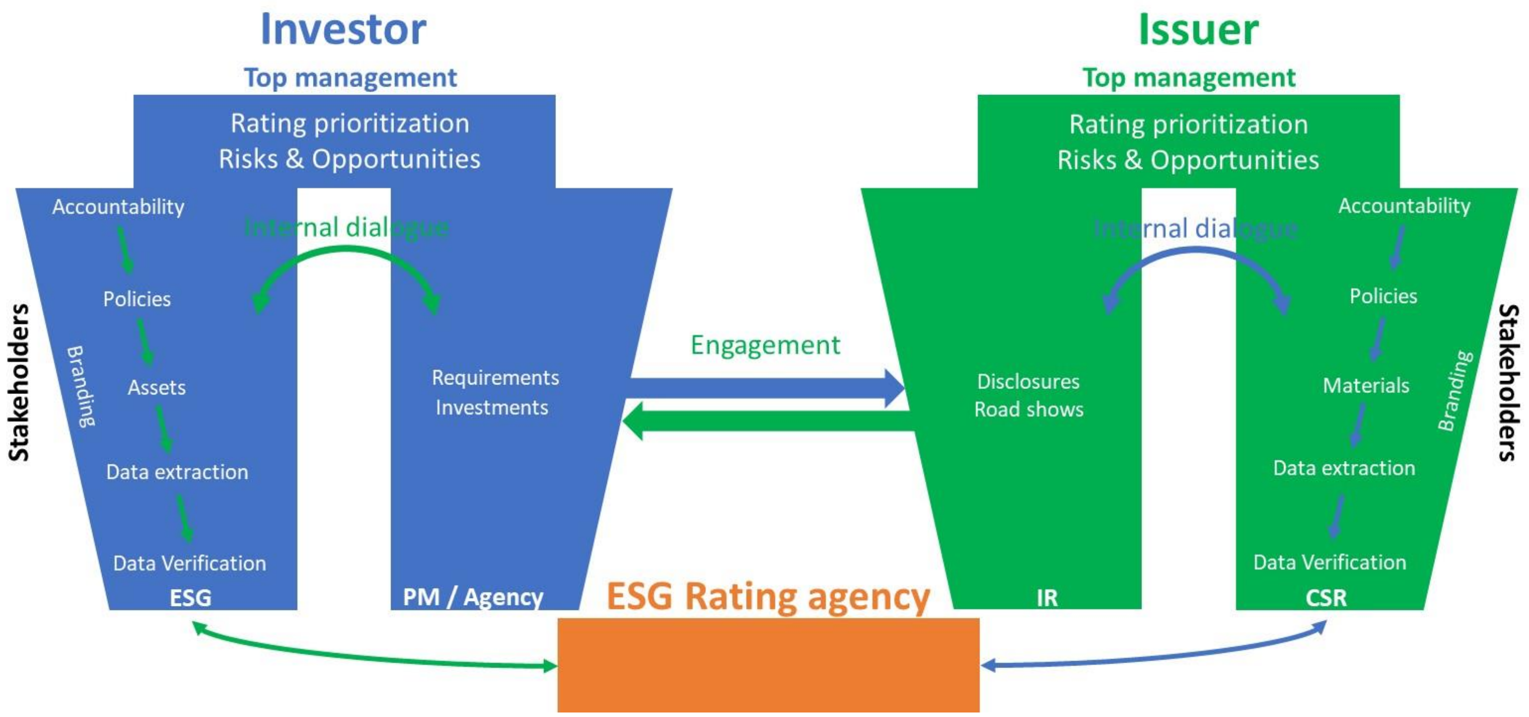
Like each other's mirror images, Issuers and Investors share a common interest in the fact that the ratings they provide data to respectively use give a true and fair view. Therefore, they can mutually benefit from each other's experience and make a concerted effort to influence Rating Agencies. Furthermore, all things being equal, it is presumed that a more direct expectation vote and a stronger cooperation between Investor and Issuer will lead to a higher degree of desired impact.

Cultural silos

Perhaps one of the major barriers to managing effectively ESG ratings is the appreciation of the differences between the organizational functions related to ESG. On the Issuer side, this manifests itself as a gap between, on the one hand, the CSR functions and, on the other, the financial department that Investor Relations often fall under. While this will not normally have a direct impact on ESG Rating, it can be of great importance to Investor Engagement on improving the Rating. On the Investor side, there may be a gap between the ESG functions and the Portfolio Managers and Investment Funds.

6. A simple approach

Based on the observations obtained during this process, CSR LINK has concluded the following approach to summarize the constraints experienced by Issuer's and Investor's between them and between the two parties and the Rating Agency. The approach is intended solely to provide a schematic representation to understand the recommendations contained in this Guide.



7. Recommendations

Issuer - Governance

1. **Roles and responsibilities**

The Board shall allocate appropriate roles and adequate responsibilities to ensure the following:

- Compliance to all legal requirements in those jurisdictions where the organization has activities.
- Risk management shall include and appropriately treat Environmental and Social issues and Ratings that can impact the organization's businesses.

2. **Oversight and reporting**

The Board shall adopt, provide oversight and report on:

- An ESG (e.g. Sustainability) policy detailing voluntary commitments and time specific targets. Targets could include Ratings inclusion and performance and Science-Based Targets.
- Cite methodologies and actions for continual improvement of the organization's impact, purpose, and ESG and Ratings performance
- Pay and incentives at all levels to reward and encourage ESG performance and achievement.

7. Recommendations

Issuer – Data (1)

3. Identification

The Issuer shall identify the relevant stakeholders, indicators, data and Ratings needed from a materiality assessment or follow an established ESG (or Sustainability) Framework.

4. Data collecting

All ESG and Ratings related data shall be collected and audited in a manner similar to financial data. ESG and Ratings data shall be verified by a third party where appropriate.

5. Data presentation

ESG data shall be presented both in absolute terms and in relevant ratios.

6. Benchmarking

For benchmarking purpose, comparative ESG and Ratings data shall be collected from competitors, industry organizations or from other databases allowing an unbiased presentation of businesses performance.

If comparative data does not exist, the Issuer could examine potential industry or sector collaborations.

7. Recommendations
Issuer – Data (2)

7. **ESG Ratings Agency approach**
The Issuer shall assess the relevant indicators, data and methodology used by the ESG Ratings Agencies and fully understand how the ESG data is compiled and ratings are calculated.

8. **ESG Ratings and Surveys comparison**
A number of ESG Ratings and Surveys should be compared to conclude the robustness of an ESG Performance Assessment. The Issuer would need to appreciate the differences and similarities between the many ESG Ratings assessments.

7. Recommendations

Issuer – Communications (1)

9. Notification of ESG Ratings Agency

The Issuer shall notify the ESG Ratings Agency of any errors in data collection or ratings compilation.

10. ESG Ratings Agencies relationship

Where appropriate and possible, it would be beneficial to develop an ongoing informal relationship with ESG Ratings Agencies.

11. Information campaign

The Issuer shall undertake a proactive information campaign on ESG impact highlighting messages from the Chairman, CEO and Senior Managers and accompanied by relevant social media content available to internal and external parties.

12. Road Shows

Relevant ESG performance and impact achievement shall be included in the Issuer's Road Shows.

7. Recommendations

Issuer – Communications (2)

13. Internal communication

The Issuer shall encourage a close communication internally across the Sustainability, Investor Relations and Human Resources Departments as directed by the Board and Senior Management.

14. Partnerships and collaboration

The Issuer shall partner and collaborate with relevant Ratings specific groups to communicate and influence ESG messages e.g. supply chain partners. This could extend to industry or segmental approach to the UN Global Compact, SDGs or other ESG Frameworks.

7. Recommendations

Investor – Governance

1. **Roles and responsibilities**

The Board shall allocate appropriate roles and adequate responsibilities to ensure the following:

- Legal compliance for all invested assets in their relevant jurisdictions and the investors' home jurisdiction.
- Risk and opportunity management shall include and appropriately treat Environmental and Social issues that can impact the Investor's businesses, portfolio and ESG Ratings.

2. **Oversight and reporting**

The Board shall adopt, provide oversight and report on:

- An ESG (e.g. Sustainability) policy detailing voluntary commitments and time specific targets. Targets could include
  - Which ESG ratings are referenced and how they are used
  - How ESG Ratings and performance would be improved
  - Science-Based Targets
  - The impact and outcomes of regular ESG performance reviews of the portfolio
- Pay and incentives at all levels to reward and encourage ESG performance and portfolio achievement. This applies to incentives to Engagement Bureaus Asset Managers and as well.

7. Recommendations

Investor – Data

3. Identification

The Investors, Engagement Bureaus and Asset Managers shall assess the quality of relevant indicators, data, their verification and the resulting assessments to evaluate ESG Ratings performance of their investments. Any incorrect data or deficient Ratings, Surveys or assessments shall be identified and corrected.

4. ESG Performance Assessment

A number of ESG Ratings and Surveys should be used to conclude the robustness of an ESG Performance Assessment. The Investor will need to appreciate the differences and similarities between the ESG Ratings scope, methodologies and assessments.

5. Compatibility and compliance

The Investor, Engagement Bureau (internal and external) and Asset Manager will need to determine compatibility and compliance with the Investor's policies and commitments and report on progress annually to Senior Management.

6. Benchmarking

The Investor could collect data / performance from other similar Investors (funds) to assess ESG and Ratings performance, and compare in a similar manner to financial performance (i.e. level and quarterly change).

7. Recommendations

Investor – Communications (1)

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