GUIDE TO

STANDARD ETHICS RATING

ESSENTIALS

What are sustainability ratings and how do they work?

INDEX

ABOUT THIS GUIDE

This guide is designed to provide an understanding of what Sustainability ratings are and how they work.
This guide:

1. Helps explain what Sustainability ratings are and are not, who uses them and how they may be useful to the stakeholders and investors.
2. Provides an overview of different business models and methodologies used by different players (such as ratings agencies or consulting firms).
3. Describes generally how Standard Ethics Rating services form rating opinions about companies and countries, monitoring, adjusting and studying their changes over time.

Standard Ethics:

1. is a Self-Regulated Sustainability Rating Agency that applies the models of credit rating agencies and provides a comparable and standardized solicited rating system suited to a modern rating agency in terms of methodology, long-term evaluations and fairness.
2. expresses independent opinions using a common terminology that helps market participants make more informed investment decisions. Standard Ethics does not advise investors and does not provide a consultancy service to its customers.
3. updates and refines its processes to align with new recommendations and principles provided by the **EU**, **OECD** and **UN**.

WHAT ARE SUSTAINABILITY RATINGS

Measuring the Sustainability of economic entities means providing comparable and third-party data on their overall compliance with international indications. The determination of a single fixed point (international documents and principles provided by the EU, UN and OECD) makes a holistic, homogeneous – and ethically neutral – comparison possible. This condition makes it possible to compare the distance that separates two entities with respect to a shared strategy or to pre-established and unambiguous quantitative targets. It is also possible to develop analysis grids and standard algorithms that make the measurement objective and falsifiable. If we consider the players implementing ESG Sustainability policies as planets orbiting around a single gravitational centre, then the rating measures the distance between them and that centre.

Standard Ethics ESG Definitions of: Sustainability, Responsibility, Sustainability rating

Definition of Sustainability

Sustainable Development policies are about the generations of the future; they have taken on a global dimension; and they are implemented on a voluntary basis. It is up to the main supranational organisations, officially recognised by nations across the globe, to establish the definitions, guidelines and ESG strategies related to sustainable development through science. Economic entities pursue – to the extent deemed possible – aims, strategies and guidelines on Sustainability, they do not define them.

Definition of Responsibility

It is a voluntary ESG action or strategy, defined by the company or investor implementing it. It may be based on valuable ethical choices arising from dialogues with stakeholders. It may not be sustainable and therefore not aligned with international guidelines. “Responsibility” is not a rateable notion.

Definition of a Sustainability Rating

Measuring the Sustainability of economic entities means providing comparable and third-party data on their overall compliance with international guidelines.

Sustainability ratings are opinions and assessments of the level of compliance of companies, and sovereign nations to Sustainability principles. Sustainability ratings are opinions and assessments about how well a company manages to balance environmental, social and governance (ESG) issues. They measure a company's ability to benefit from opportunities and manage risks in the mid- to long-term.

A **sustainability** rating should resemble a credit rating: a third-party opinion, based on a standardised analyst-driven process and a validated proprietary algorithm. However, the term **ESG** Rating is also often used to refer to the ratings provided by investors themselves (or by their constituents) on the basis of their investment objectives or their views on ESG. In ESG evaluation, each player applies its own methodology in measuring non-financial issues and uses a specific rating scale to publish its opinions, although the European Commission and other international bodies are proposing shared taxonomies, methods and measures.

Sustainability ratings represent a powerful tool for companies to build competitive advantage and show investors and stakeholders their ESG commitments.

According to studies, sustainable companies are more able to identify new products, are more attractive for employees, therefore retaining important know-how, foster innovation, strengthen their reputation and reduce the potential impact of legislation and standards.

WHO USES SUSTAINABILITY RATINGS

Investors

Investors most often use Sustainability ratings to help assess reputational risk and to compare different applicants when making investment decisions and managing their portfolios.

Today, long-term and Institutional investors, including mutual funds, pension funds, banks, and insurance companies, use sustainability ratings to supplement their own financial analysis of specific applicants. In addition, institutional investors may use sustainability ratings to establish thresholds for reputational and operational risks and investment guidelines.

For many investors and analysts, applying for a Solicited Sustainability Rating is, by itself, a mark of seriousness and excellence because it is based on independent assessments performed by a specialised agency that does not confuse analysis with management consultancy, certification or audit.

Stakeholders

Being assisted by a rating agency motivates stakeholders and employees to cooperate with their companies to face a common and constructive challenge by improving relationships in order to achieve optimum internationalization. The market values each effort to comply with Sustainability indications. In relation to other approaches like CSR that are less measurable and comparable, corporate communication benefits in terms of incisiveness and clarity.

Applicants

Applicants are corporations and nations that pay a Sustainability Ratings Agency, operating on the basis of an Applicant-Pay Model, to obtain an independent Rating. They can use sustainability ratings to have an independent view of their reputational and operational risks or to provide an external independent opinion of their sustainability. Applicants may also use sustainability ratings to help communicate the relative risk they bear, thereby expanding the universe of investors and stakeholders.

Businesses and financial institutions

Businesses and financial institutions, especially those involved in credit-sensitive transactions, may use sustainability ratings, along with credit ratings, to assess counterparty risk, which is the potential risk that a party to an agreement may not fulfill its financial obligations. For example, in deciding whether to lend money to a particular organization or in selecting a company that will guarantee the repayment of a debt issue in the event of default, a business may wish to consider the counterparty risk.

HOW AND BY WHOM ARE AGENCIES PAID FOR THEIR SERVICES

Companies that issue ESG ratings or rankings - often erroneously referred to as "ratings" - adopt a variety of ways to issue their evaluation. The differences are not only In the analysis model. In fact, they all also differ according to several levels of independent assessment and to whether the rating is directly requested by the applicant (Solicited Ratings) or by investors, asset managers and funds:

- **Investor-pay model**. Under the investor-pay model, ESG experts **charge investors and funds** a fee for providing a list of investable companies. Most of the time these analysis are tailored-made according to the ESG definitions given by the investors themselves.
  This is definitely the most widespread approach.
  Critics of this model point out that the ratings are available only to paying subscribers and investors. These tend to be large institutional investors, leaving out smaller investors, including individual investors. In addition, rating agencies using the investor-pay model may have more limited access to applicants.

- **Applicant-pay model**. Under the applicant-pay model **rating agencies charge applicants** a fee for providing a ratings opinion. From the moment it is assigned, the rating (and the analysis) belongs to the applicant.
  In this case, the applicant-pay model is similar to the one adopted by credit rating agencies.
  Until today, Standard Ethics is the only Sustainability rating agency following the applicant-pay model, therefore focusing its core business on solicited ratings without offering asset management consulting to institutional investors.
  Standard Ethics obtains information that is already disclosed or can be disclosed, without taking into consideration the one not available to the public. Transparency and fair use of the same information is a milestone in Sustainability.

RATING METHODOLOGIES

To formulate their opinions on Sustainability risk, analysts can use two different models: the **analyst-driven** or the **questionnaire-driven** model:

- **Questionnaire-driven ratings.** ESG experts used to send questionnaires to companies or use published reports to assess the entity's Sustainability condition.
  Usually, this approach is adopted by agencies following the investor-pay model, needing to update a database and providing a tailor-made analysis to various institutional investors.

- **Analyst-driven ratings**. Agencies using the analyst-driven approach generally assign an analyst, often along with a team of specialists, to take the lead in evaluating the entity's Sustainability. Typically, analysts obtain information from published and publishable reports, as well as from interviews and discussions with the applicant's management. They use that information and apply their analytical judgment to assess the entity's Sustainability condition, operating performance, policies, and risk management strategies and reputational risk.
  This approach is similar to the one adopted by credit rating agencies. Standard Ethics, acting as a Solicited Sustainability Rating agency, adopts this model.

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Solicited Sustainability Ratings

THE STANDARD ETHICS RATING (SER) ©

The Standard Ethics Rating (SER) © is a Solicited Sustainability Rating that has been used as a benchmark over the last 14 years. The sustainability rating that distinguishes itself because at the same time is:

- **Solicited,** because it is issued only on request by an applicant, the recipient of the rating;
- **Standard,** because any rating is always comparable to others since the algorithms are aligned to the same guidelines. For this reason, clients or other third parties cannot change the agency's principles of evaluation or change the procedures for issuing ratings;
- **Independent,** because its assignment is incompatible with the supply of other services, research and consulting activities related to the data collected. Furthermore, no common financial and economic interests exist between the rating agency and the applicant.

THE RATING SCALE

STANDARD ETHICS RATING (SER) © grades

Standard Ethics rating scale is a benchmark to evaluate the relative risk and also compliance of the Applicant. The final evaluations by Standard Ethics are expressed with nine different grades.

Those nations and companies which do not comply with the values expressed by the UN, OECD and EU, or that do not release enough information, or are facing major changes, do not receive ratings and are included amongst the "**pending**" issuers.

General summary of the opinions reflected by the rating:

- **EEE,** Full compliance
- **EEE-,** Extremely strong compliance with the values expressed by the UN, OECD and EU. And, strong ability to manage risks
- **EE+,** Very strong compliance and ability to manage reputational risks linked to UN, OECD and EU agenda on Sustainability
- **EE,** Strong compliance and ability to manage reputational risks linked to UN, OECD and EU agenda on Sustainability, but somewhat susceptible to changes in circumstances
- **EE-,** Adequate compliance and ability to manage reputational risks linked to UN, OECD and EU agenda on Sustainability, but more subject to changes in circumstances

-------------------- "**EE-**" level or above, indicates a good compliance-------------------

- **E+,** Low compliance and ability to manage reputational risks linked to UN, OECD and EU agenda on Sustainability, but with margins of improvement to get into the "***compliance zone***"
- **E,** Low compliance and ability to manage reputational risks linked to UN, OECD and EU agenda on Sustainability
- **E-,** Very Low compliance and ability to manage reputational risks linked to UN, OECD and EU agenda on Sustainability
- **F,** Considered the lowest level of compliance and to manage reputational risks linked to UN, OECD and EU agenda on Sustainability

Ratings and level of compliance		Capability to respond appropriately to a reputational crisis
EEE	Full	Strong
EEE-	Excellent	
EE+	Very strong	
EE	Strong	Good
EE-	Adequate	
E+	Insufficient	Low
E	Low	
E-	Very Low	Weak
F	Lowest level	

Standard Ethics opinions **are not predictive** and, therefore, do not primarily focus on the analysis of positive or negative events and their future effects.
Nevertheless, as the economist Irving Fisher used to say: “The future casts its shadow on the present”. Therefore, the analyses on policies and governance highlight levels of implicit vulnerability vis-à-vis the future.

The Standard Ethics Rating measures the vulnerability that might come from economic, operational and reputational risks. The latter ones, unlike the most common practices, have been classified by Standard Ethics since 2011 as primary and secondary risks where primary reputational risks are standalone risks not deriving from operational risks. This classification introduces original elements in vulnerability analysis and leads to believe that companies with at least a “double E minus” are structurally better positioned to withstand seriously negative events (either economic, operational or reputational) and capable of reducing their potential frequency.
Following this approach, in case of negative events, Standard Ethics analysts evaluate the adequacy of organizational adjustments made by companies to reduce the risk of a similar event taking place again.
Only if, over a reasonable period of time, suggested solutions appear to be inadequate for the rating assigned to a company, a new rating will be proportionally assigned so that the most suitable level is reached.

standard ethics
Solicited Sustainability Ratings

WHY STANDARD ETHICS RATINGS CHANGE

The reasons for ratings adjustments vary, and are mostly related to changes in companies' policies that might distance or near the compliance to international guidelines.
In some cases, changes in the governance and policy can affect the Sustainability risk. For instance, a new board of directors, changes to the shareholding structure, shareholders' agreements may affect a company's Sustainability, which could lead to rating downgrades or upgrades over time. Also, international indications improvements may also trigger ratings changes when the company does not make changes in line with what suggested by the international bodies.

EXPRESSIONS OF CHANGE: OUTLOOK AND UNDER MONITORING

If Standard Ethics anticipates that a Sustainability rating may change in the coming 6 to 24 months, it may issue an updated ratings **outlook** indicating whether the possible change is likely to be "positive" "negative" or "stable". Or, if events or circumstances occur that may affect a Sustainability rating in the near term, usually within 90 days, Standard Ethics may place the rating on **Under Monitoring**. Typically, an updated outlook or Under Monitoring from Standard Ethics includes a rationale for the potential change and the extent of the change, up or down that may occur. However, updating a ratings outlook or placing a rating on Under Monitoring does not mean a ratings change is inevitable.
If Standard Ethics has all the information available to warrant a ratings change, it may upgrade or downgrade the rating immediately, without placing the rating on Under Monitoring or changing its outlook, to reflect these circumstances and its current opinion of relative risk.

STANDARD ETHICS INDICES

Standard Ethics Indices are a benchmark to measure, over time, the appreciation in financial markets of the principles and indications from the European Union, the OECD and the United Nations on matters of Sustainability.

The Sustainability score is applied; therefore, companies more compliant with those international indications weigh more in the indices.

The methodology of selecting the constituents and the weights are public and easy to understand. In fact, the indices are freely usable as a benchmark in the area of ESG investing, as reputational risk indicators and also can be compared against their market cap based counterparts.

Independent studies on Standard Ethics Indices

Standard Ethics Rating performance is measured by independent studies:

- Academic studies have historically shown a positive correlation between higher ratings and better stock performance.
- Academic studies have shown that companies with higher ratings have also better financial ratios.
- Academic studies have also shown that companies with higher ratings have lower volatility.

The overall consistency of ratings performance demonstrated by these studies has helped to establish Standard Ethics ratings as useful benchmarks of relative Sustainability and risks.

UNSOLICITED RATINGS

Standard Ethics, in order to maintain and update or develop its indices, may issue Unsolicited Ratings.
Standard Ethics uses the same methodology as for Solicited Ratings, however only public documents are analyzed and there is no issue of dedicated reports.

Standard Ethics Rating: basic conditions for listed companies

The basic conditions that listed companies have to meet are as follows:

- to hold a competitive position and not a monopolistic one and not being linked to cartels;
- to make sure that their shares are listed and can be bought without restrictions and that they enjoy substantive rights (voting trusts, for instance, are not acceptable);
- to have widespread ownership of the capital or no conflict of interest;
- all Board members must be independent of capital ownership and must abide by a Code of Conduct that ensures transparency;
- to have procedures to check observance of the latest internationally recognized social and environmental standards (according to UN, OECD and EU guidelines).

Further positive elements are: transparent staff selection (including managers); an independent internal monitoring body (liaising with the Shareholders' Meeting and working at Board level) to check that the Board works in line with the latest UN, OECD and EU standards and principles on conflicts of interest and Corporate Governance; an independent internal monitoring body (e.g. the Audit Committee) which is accountable to shareholders and monitors that the Board works in line with the latest UN, OECD and EU standards and principles on extraordinary accounting and finance; an internal body which reports and facilitates the company's adherence to the latest international social and environmental standards and principles; an external relations and communications department which works in line with the latest standards and principles on sustainability and transparency and applies with due independence the "comply or explain" principle whereby failure to comply with international guidelines on sustainability has to be duly motivated.

HOW STANDARD ETHICS RATINGS ARE DISCLOSED

In general, Standard Ethics does not publish **Solicited Standard Ethics Ratings** because they belong to the Applicant who can decide whether to disclose them or not. This is not the case for **Ratings** issued to listed companies that are constituents of Standard Ethics Indices, whether they are solicited or unsolicited.

Standard Ethics follows standard procedures to disclose the ratings. The release of new ratings, downgrades and upgrades are communicated through **press releases**, which take into account **Press Release Guidelines published by ESMA**.

MANAGING POTENTIAL CONFLICTS OF INTEREST

As in the case of credit rating agencies, critics here point out that both models have the potential for conflicts of interest since the entities paying for the rating, investors and companies, may attempt to influence the ratings opinion.

In order to mitigate that, Standard Ethics has taken a number of steps to protect against potential conflicts of interest: self-regulates based on the model of the credit rating agency, adheres to the **Applicant-pay Model** and does not act as a consultant to investors or investment funds.

These measures include, for example, a clear separation of function between those who negotiate the business terms for the ratings assignment and the analysts who conduct the analysis and provide the ratings opinions.

Another safeguard is the **Rating Committee** process that limits the influence any single person can have on Standard Ethics' ratings opinions. The role of the Committee is to review and assess the analyst's recommendation for a new rating or a rating's change as well as to provide additional perspectives and checks and balances regarding adherence to the agency's ratings criteria. Standard Ethics client business managers, who respond to applicants' rating requests and deal with commercial matters such as pricing, contract negotiations, and maintaining client relationships, do not participate or vote in rating committees.

A further safeguard is the appointment of the **Compliance Officer** that has access to all documentation of the Company for which she/he deems necessary to carry out his controlling and supervisory role and can independently report likely conflicts of interest.

Finally, the **Board of Directors** (complying with the international guidelines on diversity of nationality, professional skills and gender equality) establishes clearly defined policies and procedures. To ensure the maximum level of independency, the Board is not involved in the issuing rating process, but appoints the Compliance Officer and the Rating Committee.

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Solicited Sustainability Ratings

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Important Legal Disclaimer.

 The Standard Ethics Rating (SER) is assigned by Standard Ethics Ltd in accordance with its established methodology on Sustainability based on the principles provided by the European Union, the OECD and the United Nations. More information is provided on www.standardethics.eu.

Solicited Ratings are assigned on a Client's request through a direct and regulated bilateral relationship.
Unsolicited Ratings are issued through official press releases only and for statistical or scientific purposes. Currently, to update Indices, as well as OECD countries ranking (including Brazil, China, Russia, India, South Africa, Egypt, Romania, Argentina, Bulgaria and Vatican City).

By issuing a Solicited or Unsolicited Rating, or publishing Indices, Standard Ethics Ltd does not supply financial, legal, tax or investment consultancy. The opinions and analyses by Standard Ethics Ltd are not, even indirectly, invitations or solicitations to purchase or sell securities or to make investment decisions. Under no circumstances will Standard Ethics Ltd be liable for damages to, loss, or reduction in the value of shares of companies following or as a result of its analyses, its Indices or Ratings.

Standard Ethics Ltd will not be held responsible for any conflict arising from the use of information or data issued by customers relating to its Standard Ethics Rating. In particular, Standard Ethics Ltd is not answerable in any way whatsoever for any decisions and/or assessments made by companies on the basis of the above-mentioned data related to the Rating service. The Standard Ethics Rating is for information purposes only and companies under Rating will be wholly responsible for any decision made on the basis of the information arising from the Rating itself.
In no event shall Standard Ethics be liable to any party for any direct, indirect, incidental, exemplary, compensatory, punitive, special or consequential damages, costs, expenses, legal fees, or losses (including, without limitation, lost income or lost profits and opportunity costs or losses caused by negligence) in connection with any use of its opinions, analyses and ratings.

The Standard Ethics Rating, if there are no other indications, is valid for twelve months from the date of issue. Standard Ethics reserves the right to modify, suspend or revoke a previously assigned Rating at any time.

The **Standard Ethics Rating** can be renewed by requesting annual visits by Standard Ethics' analysts without having to start the entire assignment procedure again. Unless updated, the **Rating's** validity ends on its natural expiry date, at which point the Client loses the right to use and publicise the Rating.
The final decision on changes to, or suspension or revocation of, the **Rating** will be communicated to the Client in writing and in a confidential manner. There will also be a request to bear the changes, suspension or revocation in mind in related company communications if the Standard Ethics Rating has been made public. If the Client does not adequately publicise the changes to the public **Rating**, Standard Ethics reserves the right to make the changes, suspension or revocation known.