Solicited Sustainability Ratings

GUIDE TO

STANDARD ETHICS RATING

ESSENTIALS

What are sustainability ratings and how do they work?

Solicited Sustainability Ratings

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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 ratings agencies.
3. Describes generally how Standard Ethics Ratings Services form ratings opinions about companies and countries, monitors and adjusts its ratings and studies ratings changes over time.

Standard Ethics:

1. Is a leading provider of **independent**, **solicited** and **standard** sustainability ratings through corporate governance assessment and company policies analysis.
2. Expresses independent opinions using a common terminology that help market participants make more informed investment decisions.
3. Updates and refine its processes to align with new recommendations and guidelines from EU, OECD and UN.

WHAT ARE SUSTAINABILITY RATINGS

Sustainability ratings are opinions and assessments about how well a company manages to balance environmental, social and governance (ESG) issues. It measures companies' ability to benefit from opportunities and manage risks in the mid- to long-term.

Ratings are provided by Sustainability and ESG rating agencies that specialize in assessing the three dimensions.

Each agency applies its own methodology in measuring ESG issues and uses a specific rating scale to publish its ratings opinions.

Awareness for rising environmental and social needs and transparent governance models made Sustainability ratings a powerful tool for companies to build a 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.

HOW AND BY WHOM AGENCIES ARE PAID FOR THEIR SERVICES

Rating companies adopt a variety of ways to issue sustainability ratings. The differences are not only on 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) or by investors, asset managers and funds:

- **Investor-pay model**. Under the investor-pay model, **rating agencies 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

In forming their opinions on sustainability risk, rating agencies typically use **analyst-driven** or **questionnaire-driven** models.

- **Questionnaire-driven ratings.** Agencies 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 (SSR) agency, adopts this model.

THE STANDARD ETHICS RATING© (SER)

The STANDARD ETHICS RATING© (SER) is a Solicited Sustainability Rating (SSR) 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,** assigned on a client's request through a direct and regulated bilateral relationship;
- **Standard,** used as a measure in comparative evaluations, being the analysis model standardized on institutional and international indications regarding sustainability, governance and CSR. For full comparability, the algorithm will take into account the economic size and type of business;
- **Independent,** the agency issuing the rating provides guarantees of impartiality and independence by providing only services related to the rating and does not carry out consultancy, does not use the data collected for other purposes or provide them to third parties, and does not own a significant ownership of shares and stocks of the Applicant.

STANDARD ETHICS ESG MODEL: an INSTITUTIONAL APPROACH

Differently from its peers and other companies, Standard Ethics does not give its own interpretation to the definition of CSR and Corporate Governance. Its model is exclusively inspired by the principles and guidelines of the **European Union, OECD and United Nations**. This approach, adopted in 2001, is called by Standard Ethics "**Institutional approach**", because it is based on Institutional guidelines and is not stakeholder-oriented.

The **competitive advantage** of Standard Ethics model is simple:

- EU, OECD and UN recommendations suggest future legislative requirements. Companies, organizations and countries adopting the Standard Ethics model will have a competitive advantage compared to those not complying with the recommendations;
- The principles of the EU, OECD and UN are universal and shared by all major international investors and stakeholders;
- Companies and their stakeholders can easily focus their discussions on common target already discussed at international level, matching common views about the road map.

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Solicited Sustainability Ratings

THE RATING SCALES

STANDARD ETHICS RATING (SER)© classes

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 classes.

Those nations and companies which do not comply with the values expressed by the United Nations, 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,** Extremely strong compliance with the values expressed by the United Nations, OECD and EU. And, strong ability to manage risks. The highest rating.
- **EE+,** Very strong compliance and ability to manage reputational risks linked to United Nations, OECD and EU agenda on sustainability and corporate governance
- **EE,** Strong compliance and ability to manage reputational risks linked to United Nations, OECD and EU agenda on sustainability and corporate governance, but somewhat susceptible to changes in circumstances
- **EE-,** Adequate compliance and ability to manage reputational risks linked to United Nations, OECD and EU agenda on sustainability and corporate governance, 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 United Nations, OECD and EU agenda on sustainability and corporate governance, but with margins of improvement to get into the "***compliance zone***"
- **E,** Low compliance and ability to manage reputational risks linked to United Nations, OECD and EU agenda on sustainability and corporate governance

- **E-,** Very Low compliance and ability to manage reputational risks linked to United Nations, OECD and EU agenda on sustainability and corporate governance
- **F,** Considered the lowest level of compliance and to manage reputational risks linked to United Nations, OECD and EU agenda on sustainability and corporate governance

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.

WHY SUSTAINABILITY 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 guidelines 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 WATCH

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 **Watch**. Typically, an updated outlook or Watch 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 Watch 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 Watch 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 guidelines from the European Union, the OECD and the United Nations on sustainability, corporate governance and corporate social responsibility issues.

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

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

Independent studies on Standard Ethics Indices

Standard Ethics Rating performance as measured by independent studies:

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

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

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Solicited Sustainability Ratings

UNSOLICITED RATINGS

Standard Ethics, in order to update Indices or to create them, can issues unsolicited ratings.

The issue of unsolicited ratings follows the same methodology adopted to issue the solicited ones, but, in this case, Standard Ethics examines only public documents and it not able to furnish analysis reports.

Even in this case, all collected data are not used for other purpose except the rating itself.

Updating Standard Ethics Indices

To update their indices, Standard Ethics may issue unsolicited ratings.

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 ;
- to have procedures to check observance of the latest internationally recognised social and environmental standards (according to the UN, OECD and EU guidelines).

Further positive elements are: transparent staff selection; 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 and applies with due independence the "comply or explain" principle.

WHO USES SUSTAINABILITY RATINGS

Sustainability ratings are a tool that investors and stakeholders can use when making decisions about purchasing company's assets and products, using their services, creating long-term relationships and investing in their shares.
Sustainability ratings serve as an additional tool to credit ratings for investors and stakeholders to have a broader view of the company's sustainability, financially and operationally.

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.
Socially Responsible Investing funds were the only users of sustainability ratings basing their investment decision process on ESG issues.
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 applicant. 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 an solicited sustainability rating (SSR) is, by itself, a mark of seriousness and excellence because 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 during this work 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 ESG guidelines. In relation to other approaches to CSR that are less measurable and comparable, corporate communication benefits in terms of incisiveness and clarity.

Applicants

Applicants, including corporations, national governments, states, cities and municipalities, use sustainability ratings to provide independent views of their reputational and operational risks.
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.

A sustainability rating agency's opinion of counterparty risk can therefore help businesses to evaluate the viability of potential partnerships and other business relationships.

HOW SUSTAINABILITY RATINGS ARE DISCLOSED

Standard Ethics does not publish **Solicited Standard Ethics Ratings**, because from the moment they are assigned they belong to the Applicant that has final word whether to disclose it or not.

Standard Ethics publish **all Standard Ethics Ratings** belonging to listed companies that are **components** of any of Standard Ethics Indices, whatever they are (solicited or unsolicited).

Any notice given by Standard Ethics on ratings, following procedures and takes place through **press releases** sent when markets are closed.

MANAGING POTENTIAL CONFLICTS OF INTEREST

Similarly for 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 when paid by applicants.
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 ratings 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' ratings 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 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 maximum level of independency, the Board is not involved in the issuing rating process but appoints the compliance officer and the rating committee.

Sustainability in Governance & Policy

www.standardethics.eu
headquarters@standardethics.eu

Important Legal Disclaimer.

 The Standard Ethics Rating (SER) is assigned by Standard Ethics Ltd in accordance with its established methodology on Corporate Social Responsibility and Corporate Governance based on the principles laid down 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).

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

The **SER** 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 SER had been made public. If the Client does not adequately publicise the changes to the public **SER**, Standard Ethics reserves the right to make the changes, suspension or revocation known.