



SUSTAINALYTICS

a Morningstar company

THE ESG RISK RATINGS

MATERIAL ESG ISSUE —
BUSINESS ETHICS



Sustainalytics' Material ESG Issue: Business Ethics

Compliance with laws, regulatory requirements, as well as following ethical business principles are integral components of companies' strategies and operations. How exposed companies are to business ethics issues and how well they manage the integrity of their business can present varying degrees of ESG risk to investors' portfolios. Sustainalytics' ESG Risk Ratings assess business ethics risks through our Business Ethics material ESG issue (MEI). Business Ethics refer to a company's management of risks related to anti-competitive practices, accounting, taxation, bribery, corruption, money laundering, defrauding, political involvement, lobbying, intellectual property rights and sanctions. In this backgrounder, we will examine why this issue is growing in importance, analyze which industries are most exposed to this issue and highlight companies that perform well on this MEI.

Business Ethics in the Spotlight

In his 2016 article "Business ethics and sustainability¹", Prof. Lashley from NHL Stenden University of Applied Sciences, discusses the key issues to be considered under business ethics, including social development and caring, social responsibility, fairness, lying, cheating, bullying, harming and the combination of the actions that are good, bad, legal and illegal. In addition to competitive pressures, business ethics risks, such as market manipulation, money laundering, violation of competitors' rights, bribery & corruption are additional constraints on value creation for companies.

Based on data by Fenergo², between 2008 and 2018, global regulatory anti-money laundering fines reached USD 26 bn. Large-scale money laundering and banking compliance system failure cases, such as the ones at Danske Bank, Swedbank and Westpac are examples of serious business ethics incidents. Similarly, the Libor rigging scandal in the early 2010s resulted in more than USD 9 bn in fines for several banks. To mitigate such illegal/unethical business practices, many regulators and authorities worldwide now require companies to have rigorous compliance systems and ethics policies in place.

There are also several initiatives to promote integrity of the markets and companies in various industries. OECD's automatic exchange of information (AEOI) to combat tax evasion and money laundering, the EU's updates on the existing anti-trust laws to control the invasive impact of the global tech-giants and the EU's 2020-2025 Action Plan in Firearms Trafficking are notable examples.

Examining Unmanaged Risk for Business Ethics Issue by Industry

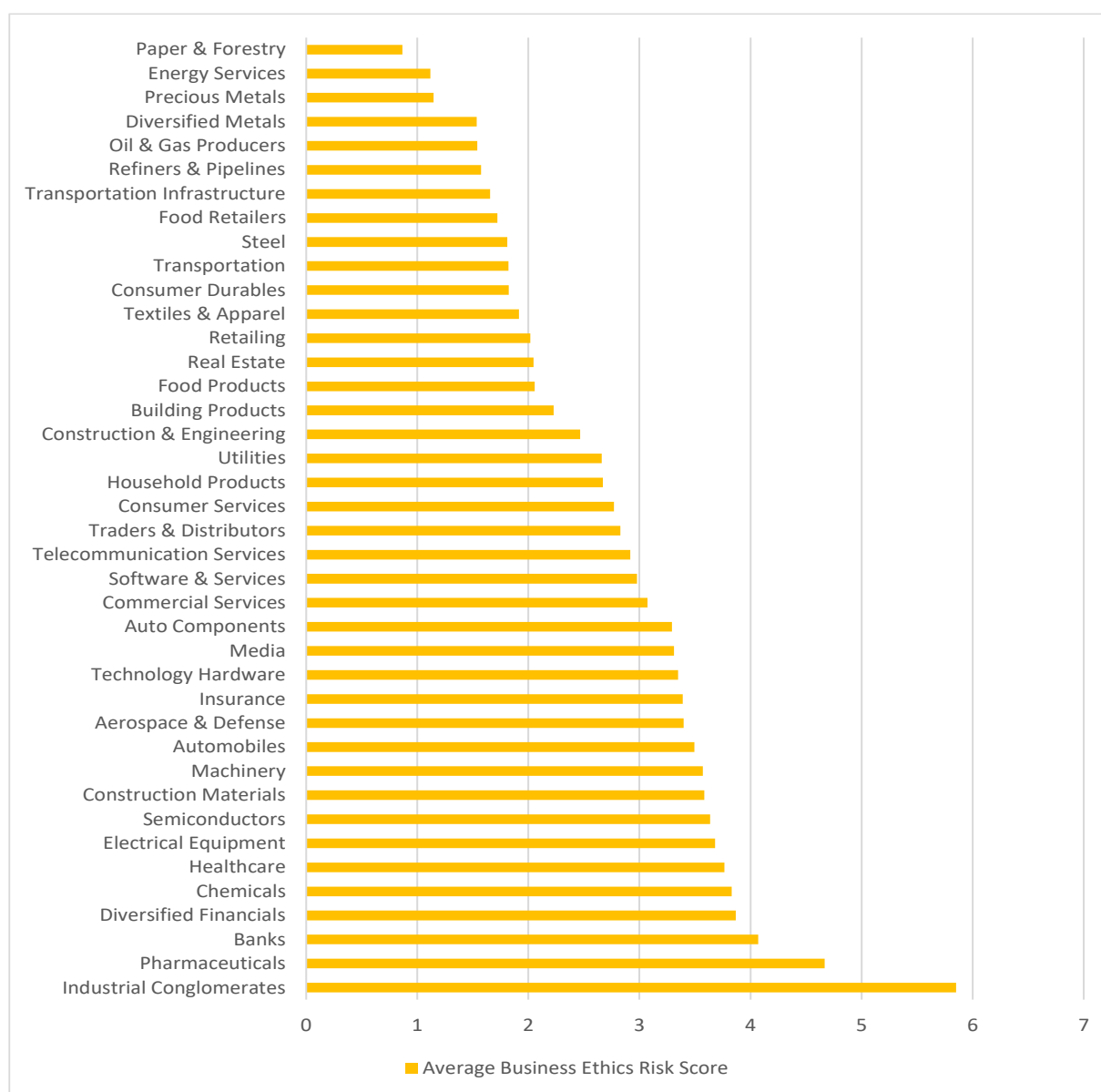
Major variables that affect subindustry exposure levels include market structures, degree of competitiveness, number of operational business lines, regulatory environment, vulnerability against business integrity and ethical controversies. Business Ethics exposure is a function of multiple factors, such as taxation and accounting, fraud, hostile rivalry and market manipulation. Having less effective company defense systems can lead to higher unmanaged risk scores, based on Sustainalytics' ESG Risk Ratings methodology. Moreover, subindustry specific topics, such as medical ethics, human rights, involvement in weapons sales, ethics related to financial services also affect industry scores.

¹ <https://www.tandfonline.com/doi/pdf/10.2989/RHM.2016.6.1.1.1289?needAccess=true>

² Fenergo, A Ten-Year Analysis (2008 - 2018) – North America Edition, A Fine Mess We're In

Sustainalytics' ESG Risk Rating on a company's business ethics includes the risk that the company is not actively managing with relevant policies, programmes and systems in place. Based on our consistent ESG Risk Ratings framework, we observe that business ethics is a material issue for 40 out of 42 industry groups and covers more than 4600 companies in our comprehensive universe. As witnessed in Exhibit 1, conglomerates have the highest unmanaged risk score, followed by pharmaceuticals, banks and diversified financials.

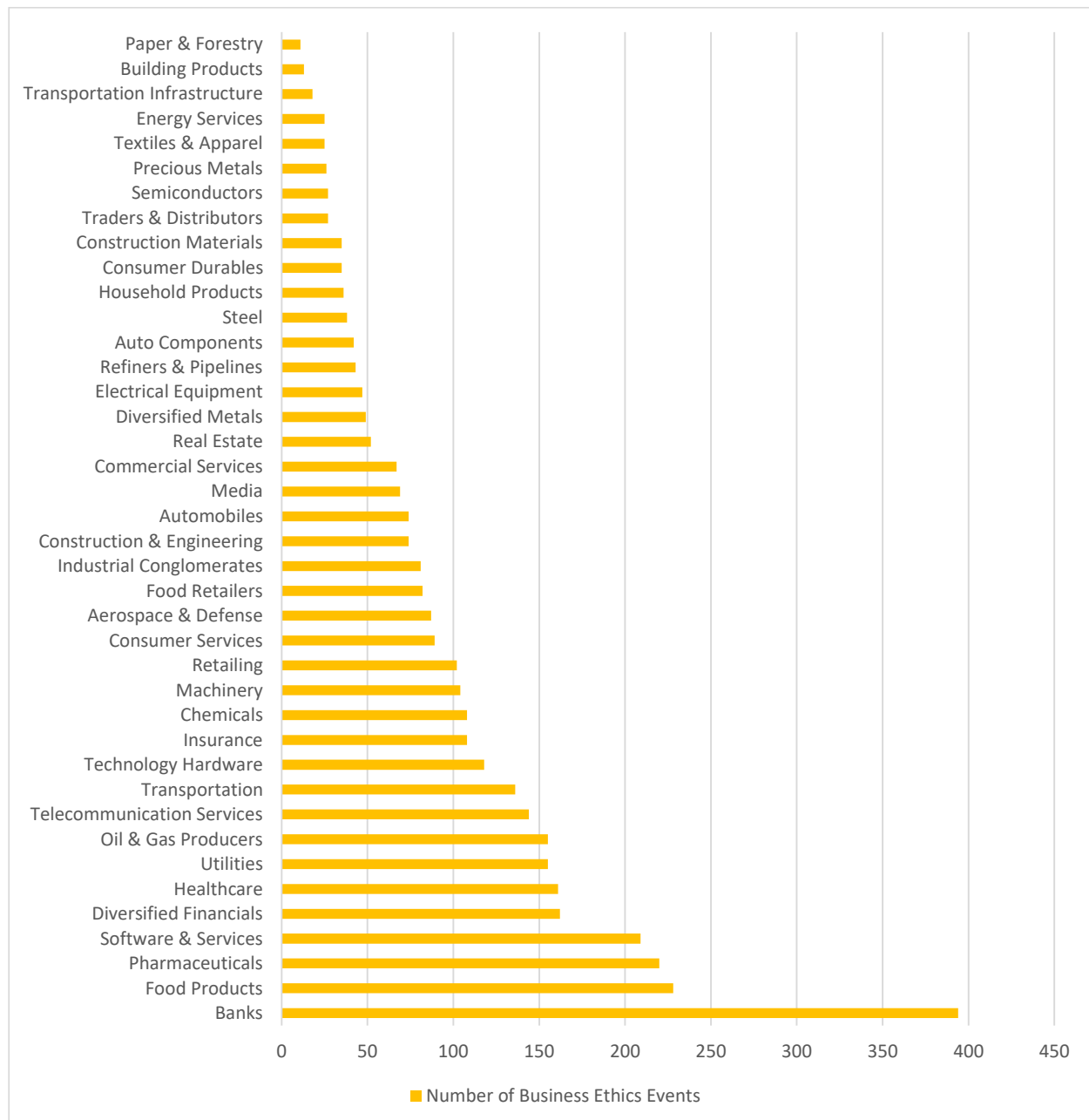
Exhibit 1: Unmanaged Risk by Industry (Source: Sustainalytics, Data as of October 2021)



While a company's relevant policies, programmes and systems can act as a shield against business ethics risks, incidents and controversies show how and to what degree such defense mechanisms can fail. As observed in Exhibit 2 below, as of October 2021, Sustainalytics detected 3,676 events, related to business ethics within our pool of 4,623 companies across 40 industry groups. The degree of the severity of the events are assessed on a scale of 1-5 (5 showing the most severe cases) based on the impact on the

stakeholders and business risk. Events are captured through our news screening of more than 700,000 news items, third-party sources or company and regulator reporting. Regarding this issue, the most events originate from indicators such as general business ethics, accounting and taxation, anti-competitive practices, and bribery and corruption. Banks have the highest number of events, followed by food products, pharmaceuticals, software services, and diversified financials.

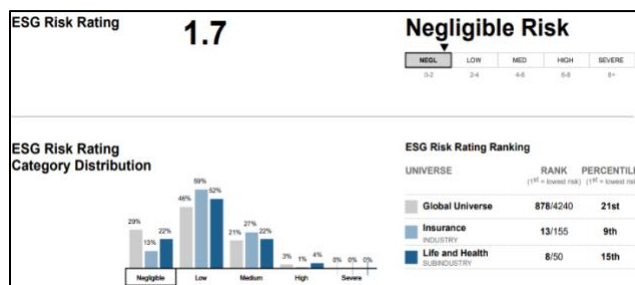
Exhibit 2: Events by Industry (Source: Sustainalytics, Data as of October 2021)



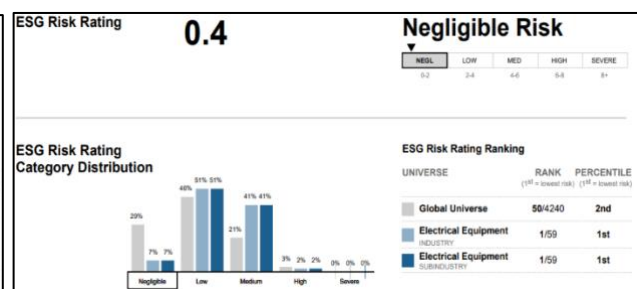
How Sustainalytics Evaluates Companies on the Business Ethics MEI

In Sustainalytics' ESG Risk Rating framework, we score companies on a set of subindustry-specific exposure and management, event and beta indicators. Business ethics programmes, bribery and corruption policies and programmes, whistleblower programmes and lobbying & political expenses are the common indicators that are assessed in the majority of industries. In addition, there are several other indicators specifically designed for certain subindustries and embedded in the business ethics MEI evaluation. Also, mainly because of uncontrollable human factors, we recognize that some portion of business ethics risks are naturally unmanageable. Hence, in our business ethics risk rating score calculations, we apply a 95% manageable risk factor. Our manageable risk factor is an integral part of Sustainalytics Risk Rating methodology and one of the parameters used in MEI level Risk Rating score formulation.

One example of a company that has strong management performance on business ethics is MetLife, a leading global life and health insurance company. The company committed to conduct business ethically and lawfully and it has a code of ethics in place, which is communicated to its employees with a mandatory training. Separately, it has a global Conflict of Interest Disclosure Program and Global Sales Practices Policy, which are strong initiatives to prevent structural misconduct and unethical sales of the products. Finally, MetLife established a robust defense shield against business ethics violations through its strong bribery and corruption policy and programmes, business ethics and compliance programmes, separate anti-money laundering policy and an antitrust guideline. In addition, low frequency of business ethics-related controversies are also another factor supporting MetLife's issue management score. MetLife's unmanaged risk score falls into the negligible risk category for the business ethics MEI and its strong management performance makes it the eighth lowest risk company within its subindustry.



Source: Sustainalytics ESG Risk Rating Report, MetLife Inc
For Informational purpose only



Source: Sustainalytics ESG Risk Rating Report, Osram Licht AG
For Informational purpose only

Another example of a strong business ethics performer company is Osram Licht AG, which is a German lighting solutions provider. Osram has an anti-trust guide to ensure all its stakeholders abide by anti-trust laws. It also has strong commitments prohibiting bribery & corruption and facilitation of payments. Another robust initiative from the company is "Tell OSRAM", which is the whistleblowing channel, available for employees, suppliers and other third parties. Like MetLife, Osram Licht has not witnessed any controversies within the business ethics field and it also helps the company's MEI risk rating score to be low. The company's policies and programmes to combat business ethics demonstrates best practice in its industry, as its ESG Risk Rating score makes it the lowest risk company in its subindustry and industry with its negligible risk category.

As the complexity of businesses increases and competition intensifies, growth and profitability pressures are natural threats to companies' integrity and executives' business acumen. Regulators and authorities are placing more scrutiny on company compliance systems, as witnessed in the banking and financial industries. The iconic examples for financial industry systemic failures were Baltic money laundering scandals with more than EUR 200 bn of suspicious transactions, collapse of compliance systems and mediation of crime financing in Southeast Asia, involvement in Fifa (World Soccer Federation) executives' corruption and facilitation of fraud in the Malaysian government and its institutions. All these controversies resulted in severe fines and sanctions for involved banks and led to further strengthening of laws and regulations. Separately, several industrial and healthcare companies have been undergoing regulatory and litigation processes because of their anti-competitive actions in their sectors. Being involved in legal or ethical misconduct not only has potential negative financial impacts, but also may pose severe reputational risks that might change the operational outlook and market presence for a company. Having a comprehensive ethical framework act as a warchest against business ethics issues. Leveraging Sustainalytics' ESG Risk Ratings, investors can clearly see which companies are most exposed to this key issue and how well they are managing their related risks.

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