



**SUSTAINALYTICS**

a Morningstar company

# THE ESG RISK RATING: FREQUENTLY ASKED QUESTIONS — FOR COMPANIES

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## ABOUT SUSTAINALYTICS' ESG RISK RATINGS

### What are Sustainalytics' ESG Risk Ratings and what do they measure?

Sustainalytics' ESG Risk Ratings are designed to help investors identify and understand financially material ESG risks at the security and portfolio level and how they might affect the long-term performance for equity and fixed income investments.

The ESG Risk Ratings are based on a two-dimensional materiality framework that measures a company's exposure to industry-specific material ESG risks and how well a company is managing those ESG Risks.

Sustainalytics ESG Risk Ratings places companies into five risk categories:

- **Negligible**
- **Low**
- **Medium**
- **High**
- **Severe**

These risk categories are absolute, i.e. comparable across sectors.

### What are the ESG Risk Rating risk categories?

A company's ESG Risk Rating score is assigned to one of five risk categories:

- **Negligible Risk** (Overall Score of 0-9.99 points): Enterprise value is considered to have a negligible risk of material financial impacts driven by ESG factors
- **Low Risk** (10-19.99 points): Enterprise value is considered to have a low risk of material financial impacts driven by ESG factors
- **Medium Risk** (20-29.99 points): Enterprise value is considered to have a medium risk of material financial impacts driven by ESG factors.
- **High Risk** (30-39.99 points): Enterprise value is considered to have a high risk of material financial impacts driven by ESG factors.
- **Severe Risk** (40 and higher points): Enterprise value is considered to have a severe risk of material financial impacts driven by ESG factors

### When did Sustainalytics introduce the ESG Risk Rating to its investor clients?

Sustainalytics introduced the ESG Risk Rating to our clients in September 2018.

# ESG RISK RATINGS METHODOLOGY

## What is a Material ESG Issue (MEI)?

A material ESG issue (MEI) is the core building block of the ESG Risk Rating. For Sustainalytics, an ESG issue is **material** if it is likely to have a significant effect on **the enterprise value** of a typical company within a **subindustry**, **and** if the presence or absence of an MEI in financial reporting is likely to influence the decisions made by a reasonable investor.

Material ESG issues for each subindustry are selected by Sustainalytics Risk Rating research team. All companies assigned by Sustainalytics to a subindustry category are assessed on how well they are managing their exposure to these MEIs.

If a MEI is not relevant to a specific company's business model, then it may be disabled.

Note that no specific predictions about financial impacts at the company level are implied by the presence or absence of an issue as a material ESG issue.

## What is the definition of Exposure to ESG Risk?

Exposure to ESG Risk is determined by a set of ESG-related risk factors that pose potential financial risks for companies. Very low exposure to an ESG risk suggests an issue is not material to a company; higher exposure suggests the issue is material.

## What is the definition of Management of ESG Risk?

Management of ESG Risk is determined by Sustainalytics assessments of management policy commitments related to an ESG risk, programs designed to implement those policy commitments, the availability of quantitative performance data measuring how well the programs have met stated targets, and how well a company is managing its involvement in related ESG controversies.

## What is the best way to interpret the Management Score?

For each MEI, the management score is a weighted sum of the management indicator scores and scored on a 0-100 scale.

Each MEI Management Score measures what percentage of a firm's *manageable risk* has been managed.

For example, assuming all a firm's exposure to risk is manageable (see **unmanageable risk**), then an MEI management score of 80 means for that MEI, the company has managed 80% of its exposure to risk.

## What is Unmanaged Risk?

The ESG Risk Rating scoring model has three scoring components for each MEI:

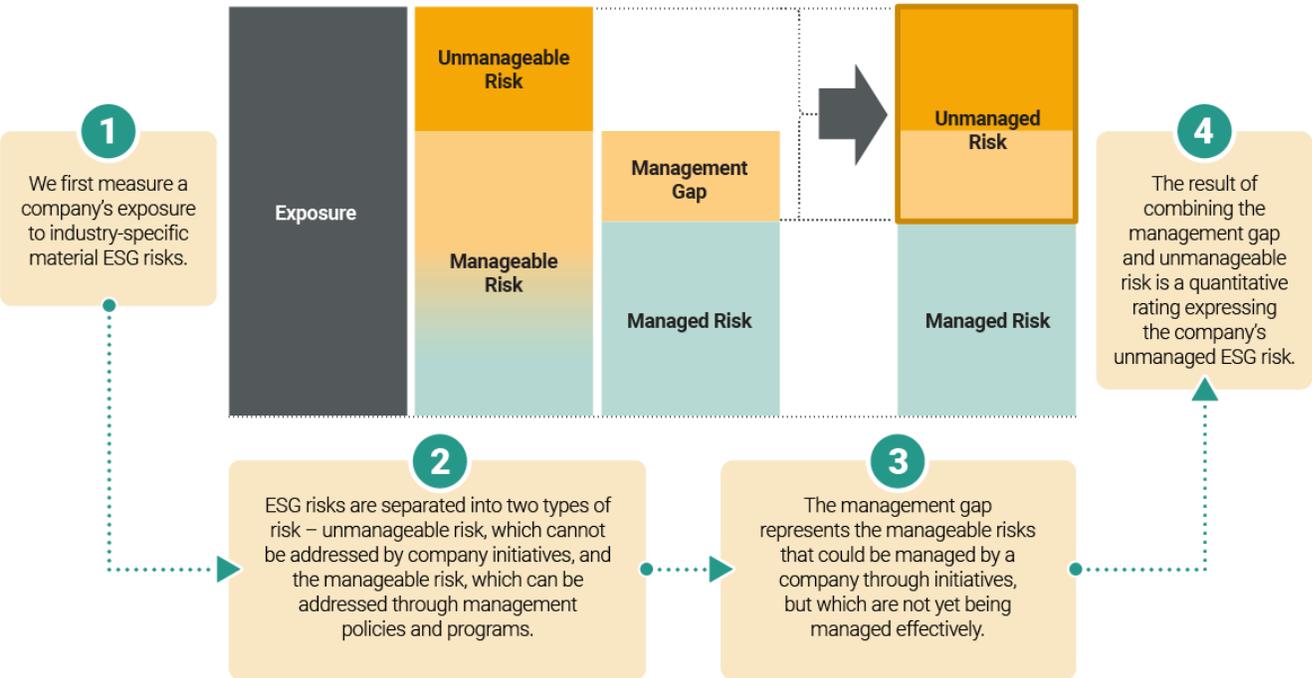
- 1. **Exposure**
- 2. **Management**
- 3. **Unmanaged Risk**
  - a. Unmanageable Risk
  - b. Manageable Risk

The overall ESG Risk Rating score represents the overall material ESG risk that **has not been managed** by a company.

It includes two types of risk:

- **unmanageable** risk i.e., which cannot be addressed by company initiatives.
- the **management gap**, which represents risks that could be managed by a company through suitable initiatives, but which are not yet managed.

Below are the key measurement components for the ESG Risk Ratings.



## How does Sustainalytics define “materiality” for the ESG Risk Ratings?

An issue is material within the ESG Risk Rating if its presence or absence in financial reporting is likely to influence the decisions made by an investor. To be selected as a material ESG issue (MEI) an issue must have a potentially substantial impact on the economic value of a company and, hence, the financial risk and return profile of an investor investing in the company.

It is important to distinguish the ESG Risk Rating's use of materiality as a concept from narrower legal or accounting-focused definitions. Not every issue we consider as material in the rating is legally required to be disclosed in company reporting.

Note that an underlying premise of the ESG Risk Rating is that the world is transitioning to a more sustainable economy, and that superior management of ESG risks should in general be associated with superior long-term enterprise value, *ceteris paribus*.

Assessments of materiality within the ESG Risk Rating are in part qualitative and require judgement, which has been provided by our experienced sector research teams in a structured and guided process. Some issues are material from an ESG perspective even if the financial consequences are not fully measurable today.

### What is an issue “beta”?

An issue beta is a factor that assesses the degree to which a company's exposure deviates from its subindustry's exposure on a material ESG issue. It is used to derive a company-specific issue exposure score for a material ESG issue. It ranges from 0 to 2, with 0 indicating no exposure, 1 indicating the subindustry average, and 2 indicating exposure that is twice the subindustry average.

### What is Idiosyncratic Risk?

Idiosyncratic Risk is additional exposure to risk caused by an issue that was not deemed material at the subindustry level but becomes a material ESG issue for a company based on the occurrence of a Category 4 or 5 event.

### Is Sustainalytics' Corporate Governance Rating incorporated into the ESG Risk Rating?

Yes. The six corporate governance pillars found in our Corporate Governance Rating form the baseline of our ESG Risk Rating. These pillars include: board and management quality and integrity; board structure; ownership and shareholder rights; remuneration; financial reporting; and stakeholder governance. Our ESG Risk Rating includes a comprehensive view of a company's governance structures, practices, decision-making and behaviors, and events.

## ABOUT OUR RESEARCH FEEDBACK PROCESS

### How often will the ESG Risk Rating be updated?

Research on management indicators is updated annually. ESG Controversy research is updated as events occur. Structural adjustments to the rating (e.g., selection of material ESG issues, weighting of indicators) are done annually.

### Can companies provide feedback during the annual update process?

Yes. Sustainalytics contacts issuers in our comprehensive universe to solicit feedback as part of our annual update of the ESG Risk Rating Report. Issuers are asked to log into our company portal – the Sustainalytics Issuer Gateway – to download and review a draft version of the report and to provide any additional information if appropriate.

### How can a company log in to Sustainalytics' company portal – the Sustainalytics Issuer Gateway?

We invite you to access our company portal - the ***Sustainalytics Issuer Gateway*** - where you will find the following:

- a complimentary copy of the Sustainalytics ESG Risk Ratings Report (comprehensive universe only)
- FAQ and methodology documents concerning the ESG Risk Rating
- Annual update schedule and draft feedback reports (during annual update cycle – comprehensive universe only)
- Information on the products and services offered to companies by our Sustainable Finance Solutions unit.

To access the ***Sustainalytics Issuer Gateway***, please go to: <https://issuergateway.sustainalytics.com/>

If you have any questions, please contact the Sustainalytics Issuer Relations Team:  
[issuer.relations@sustainalytics.com](mailto:issuer.relations@sustainalytics.com)

### Is there a deadline for feedback to be provided from an issuer to Sustainalytics?

Issuers are given two weeks to review the accuracy and completeness of the data collected. If issuers provide feedback within the allotted time frame, then this information is reviewed by the analyst prior to the release of the updated report to Sustainalytics' clients. Information provided after this deadline will be processed but the timing of the update will be variable. Deadline extensions are also available.

## What happens if a company misses the feedback deadline?

If an issuer does not respond within two weeks, the updated ESG Risk Rating Report is published without feedback. If the issuer ultimately provides feedback, Sustainalytics will integrate relevant data as soon as possible and republish the ESG Risk Rating Report.

## How can a company review its ESG Risk Rating and scoring details?

For companies in the **Comprehensive ratings framework**, please access our company portal – the **Sustainalytics Issuer Gateway** – where you will find the following:

- a complimentary copy of the Sustainalytics ESG Risk Ratings Report (comprehensive universe only)
- FAQ and methodology documents concerning the ESG Risk Rating
- Annual update schedule and draft feedback reports (during annual update cycle – comprehensive universe only)
- Information on the products and services offered to companies by our Sustainable Finance Solutions unit.

To access the **Sustainalytics Issuer Gateway**, please go to: <https://issuergateway.sustainalytics.com/>

For companies in the **Core ratings framework**, please request your ESG Risk Rating report from the Sustainalytics Issuer Relations Team: [issuer.relations@sustainalytics.com](mailto:issuer.relations@sustainalytics.com)

If you have any questions, please contact the Sustainalytics Issuer Relations Team: [issuer.relations@sustainalytics.com](mailto:issuer.relations@sustainalytics.com)

## How should an issuer contact Sustainalytics?

If you have any questions, please contact the Sustainalytics Issuer Relations Team: [issuer.relations@sustainalytics.com](mailto:issuer.relations@sustainalytics.com)

## ADDITIONAL QUESTIONS

### How is Sustainalytics research universe determined?

Sustainalytics Risk Ratings universe covers over 12,000 companies. Our research universe is determined by 25-30 major global and regional equity and fixed incomes indices.

### What is the difference between the Comprehensive Rating Framework and the Core Rating Framework?

*The Comprehensive Rating Framework:*

- Companies covered by the Comprehensive Rating Framework are primarily large and medium cap companies.

- The Comprehensive Framework assesses between 70-90 management indicators per issuer.
- These indicators are selected by relevance both to the assigned peer group (a subindustry in Sustainalytics industrial classification system) and to the particularities of a company's business model.
- In the Comprehensive Rating Framework, the overall Risk Rating score is the summation of the scores on 3 to 10 material ESG issue risk ratings scores.

### *The Core Rating Framework:*

- Companies covered by the Core Rating Framework are primarily small cap companies.
- The Core Rating Framework assesses between 20-30 management indicators per issuer.
- Core Ratings framework management indicators are chosen for their **predictive ability** to signal an issuer's performance on managing key ESG issues. By evaluating a select set of indicators, we are able provide a high-level assessment of a company's overall management of ESG risks that is **directly comparable** to assessments of similar companies in the Comprehensive Ratings Framework.
- In the Core Rating Framework, the overall Risk Rating score is NOT derived from separate MEIs risk rating scores but calculated at the company level.

## What is a subindustry and how many are there?

Sustainalytics has its own industry classification system that categorizes companies into peer groups. This classification is based on an assessment of business operations, products and services, and takes into account common environmental, social and governance challenges.

As of August 2020, Sustainalytics had created 138 peer groups – “subindustries” – that are placed into 42 distinct “industries”.

## How does the overall company score for the ESG Risk Rating differ from the overall company score for the legacy ESG Rating?

Although both scores use a range of 0-100, a lower score in the ESG Risk Rating is better than a higher score, whereas for the ESG Rating a higher score is better than a lower score.

It is important to keep in mind that the scores were designed to capture different dimensions of a company's ESG performance. The ESG Risk Rating score reflects how much of a company's exposure to ESG risk is unmanaged. The ESG Rating score reflects how well a company is managing its material ESG issues.

## Where can I find the peer group ranking and percentile metrics in the ESG Risk Ratings?

Sustainalytics lists the overall universe, industry (equivalent of peer group in the ESG Rating) and subindustry rankings and percentiles in the subindustry overview section on page one of the ESG Risk Rating report.

