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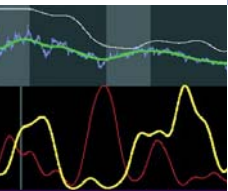


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More Transparency, more Efficiency, more Acceptance

econsense discussion paper on the future
of sustainability ratings and rankings



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Sustainable development and financial markets

More Transparency, More Efficiency, More Acceptance –

econsense discussion paper on the future of sustainability ratings and rankings

3rd updated version¹, March 2009

Companies, policy makers and society face the challenge of turning principles such as sustainable development and Corporate Social Responsibility (CSR)² into tangible and credible actions. Sustainability ratings and rankings³ evaluate companies according to the way they handle economic, ecological and social opportunities and risks. They therefore play an important informative role in the markets and the competitive business environment. This econsense discussion paper is presented as a basis for an open and continuous dialogue between business, the financial markets and the media, to jointly further develop integrated corporate evaluations.

¹ 1st version March 2007, 2nd version May 2008. The updated versions are based on discussions and workshops with experts from companies and rating/ranking agencies.

² For the sake of simplicity, this paper will use the term sustainability.

³ A rating is understood as a systematic qualitative evaluation of the creditworthiness of the issuer. *Sustainability ratings* analyse and rate the ESG performance (environment, social, governance) of companies. In *sustainability rankings*, the corporate activities in the three parameters are rated according to set criteria and then sorted into rank order.

Why is corporate ESG performance rated?

Sustainability ratings and company rankings play an increasingly important role in corporate evaluations. They are based in particular on the analysis, assessment and comparison of corporate ESG performance (environment, social, governance); in other words, the way companies handle opportunities and risks at an environmental, social and governance level.

The increasing significance of extra-financial indicators for corporate success and corporate evaluations reflects the growing interest of the capital markets in issues concerning sustainable development and corporate sustainability. Although this falls far short of a paradigm change, and there are still more questions than answers on the role played by the sustainability concept in the financial markets, one trend is obvious: players in the financial markets make use of an increasing number of data sources because they want focused information on the social and environmental aspects of corporate performance, and because there is a rising interest in reliable information. Social pressure groups and investors also now recognise that the capital market acts as an important driving force for sustainable business practices.

The aim of a comprehensive company evaluation is to improve the identification and understanding of the corporate risks, as well as the aspects boosting corporate value. There are now forums and initiatives around the world in which the financial industry exchanges ideas and concepts on the latest developments and future scenarios for Socially Responsible Investment (SRI). These include international conferences, the Enhanced Analytics Initiative, and the "Who cares wins" initiative of the Global Compact. Numerous investors and analysts have also signed the "UN Principles for Responsible Investment (PRI)" - an initiative of the United Nations Environment Programme Finance Initiative (UNEP FI) and the UN Global Compact. The signatories thus commit themselves to incorporate ESG performance in their corporate decision-making processes. In addition, numerous funds and indices have been launched with professed sustainability orientations.

The challenge facing sustainability ratings

An independent market of information service providers has also evolved in the wake of these developments, and also as driving forces behind these moves. Their business models concern the analysis and rating of companies according to sustainability criteria. Sustainability rating is undertaken by specialist rating agencies, analyst departments in banks and pension funds, the operators of (securities) indices, as well as classic credit rating agencies whose lines of business have been expanded to include this aspect. In addition to other target groups, their main clientele includes investors.

Sustainability rating agencies thus form a link between investors and companies – analogous to classic credit rating. Unlike the latter, however, which can already boast an established role in the financial markets in a field which is dominated by a few major players, sustainability

rating is a relatively recent development: the market is very dynamic, free of government regulation, and characterised by many small agencies falling back on very different methods and with a huge range of motives. The rating agencies are involved in a very demanding task which is predicated upon high levels of methodological competence and in-depth understanding of the specific business sectors.

The general discussion on sustainable development and CSR defines the horizon of sustainability ratings. The many different approaches used for these ratings therefore reflect the difficulties arising from these complex issues. Everything boils down to the question: how can the quality of the management of social, ecological and economic risks and opportunities be analysed and rated in a balanced and uniform way? There is currently no generally accepted set of information, Sustainable Development Key Performance Indicators (KPIs), or surveying and rating methods on corporate sustainability. This applies particularly to the strategic and conceptual facets of a company which are considered very significant in the ratings, and whose weighting will probably continue to grow.

The market for sustainability ratings and rankings currently covers the whole spectrum from totally subjective to totally objective criteria when it comes to information sources and possible rating methods. Although each rating is therefore based on different points of reference, they initially at least can all claim to be justified in principle. Even a high level of subjectivity in a rating does not automatically mean that it is of lower quality. The critical criteria for all rating methods remain the same: transparency and comprehensibility.

Questions on the applicability of analytical concepts and methods, and quality and transparency in general, will therefore become all the more urgent. Basic doubts are beginning to be raised about the sense and usefulness of some ratings, and some even go so far as to question the model lying at the very heart of sustainability ratings if they cannot be comprehended. This therefore raises the question of the conditions required to enable sustainability ratings, and the company analysis on which they are based, to develop optimally in future.

The challenge facing sustainability rankings

The ESG performance of companies is not only looked at by financial analysts and rating agencies: in parallel to their performance on the financial markets, consulting companies, research institutes and media organisations are also increasingly evaluating companies in the form of sustainability rankings. The intention of these sustainability rankings is to make comparisons between companies easier, as well as to publicise them in the media. In some cases a differentiation is made according to company size, in others according to the sector in which the company operates.

In some of these rankings, the ESG performance of the companies is compared on the basis of selected indicators and methods; in others, the ranking exclusively analyses company reporting, i.e. corporate sustainability reports. The results are usually published in well known

newspapers and magazines, and therefore attract a lot of public interest.

econsense believes that sustainability rankings open up opportunities: if a company has a particularly high level of commitment, this should be reported by the media. Objective ranking provides an opportunity to raise the awareness of a broader public to the outstanding sustainability commitment. From the point of view of the business community, this therefore gives rise to important aspects which should be especially highlighted in a ranking.

As already discussed in the context of ratings, the prerequisites for serious and meaningful ratings are objective indicators and scrupulous methodological analysis. This is the key requirement if ratings and rankings are to satisfy their self-made claim of creating market transparency and comparability. In international benchmarking in particular, proper consideration must be accorded to the different laws and political distinctions in some countries, to remove any possible distortions from the comparisons. And with respect to the relevance of ranking results published in the media, it must be in the interest of all stakeholders that the important topic of sustainable development in general is promoted on the basis of methodologically established analysis. The goal being to boost the sustainable public acceptance for the action taken by companies, and their reporting in this regard.

Strengthening sustainability ratings and rankings through dialogue

As an organisation representing major, multinational companies with a significant presence in the German economy, econsense is a platform for these discussions, and harnesses the opportunities created by this network. All of econsense's member companies are involved with ESG ratings. We consider it prudent to bundle our experience and make it generally available to boost transparency, efficiency and acceptance.

As companies, we are primarily "rating and ranking objects". This means:

- We are directly affected when ratings are prepared because we wish and are requested to make specific detailed information available (in reports, questionnaires, etc.) – a process which nevertheless involves a not inconsiderable amount of work: "questionnaire fatigue".
- We are directly affected by the relevant ratings because they have an impact on the reputation and awareness of a company in the financial markets and in the public sphere.
- We wish to gain the best possible benefits from a rating for our own business processes: learning from results, and improving the analysis of our strengths and weaknesses through benchmarking. Rating and ranking agencies are seen by companies as stakeholders – sources of important information revealing what interests and concerns investors.

Thus, companies naturally have an overriding interest in *transparent, efficient and methodologically viable* rating techniques.

From the experience we have all gained with research and rating processes, we are convinced that sustainability rating and ranking has reached a point in its development where

new impetus is required to establish more purposeful dialogue. The job now is to upgrade the content so that all of the players involved gain more benefits from the process and the results than is currently the case. This also reflects and supports the overriding goal of strategically further developing the concept of sustainability overall, and boosting its acceptance – amongst companies, society and in the financial markets. The future of the ratings and rankings ultimately depends on whether this approach succeeds.

econsense considers its dialogue approach to have been strengthened by the observation that the rating agency sector itself is now also particularly involved, in a more intense and self-critical manner, in the debate on the methodological future of sustainability ratings. It is scrutinising its own business in a process of analysing and learning, and recognises the need to strengthen the credibility of ratings, and the level of trust in the rating agencies.

The tone is set here by “quality” and “transparency”. Expert articles, studies and conferences, as well as all the work concerning the first voluntary quality management standard "CSRR-QS – Voluntary Quality Standard for Corporate Sustainability and Responsibility Research" and the associated "Transparency Matrix", highlight this focus. Some research organisations have also banded together to form a small umbrella organisation "Association for Independent Corporate Sustainability and Responsibility Research (AICSRR)". econsense welcomes this development.

A frequently heard demand is that there should also be “rater ratings”. econsense does not consider this to be one of its briefs: rating the raters is not the responsibility of the companies being scrutinised by the analysts, but rather other stakeholders such as the clients of the rating agencies or research institutions. It is the clients who ultimately decide through their market behaviour which ratings are successful and which are not.

Theses and themes for dialogue on sustainability ratings and rankings

1. Transparency and comprehensibility: Improving the transparency of sustainability ratings and rankings is the most crucial aspect in the opinion of econsense members. We wish to comprehend how corporate performance is assessed. Involved here is the evaluation of an extremely complex set of corporate performance parameters. The relevance of specific criteria is vigorously contested depending on the particular sector involved, and it is often not even possible to make a clear distinction between whether a criterion has been “satisfied” or “not satisfied”. Transparency should therefore be the highest priority in the whole rating process. This is because rating processes can only be sustainable when they are always comprehensible, when their basic assumptions are regularly checked, and when some of the analysis steps are scrutinised and made more efficient. This places particular responsibility on the juries that are often convened in the case of publicly oriented awards, where they take on the important function of decision-making authority. The role of a jury should be to develop the methodological framework for the evaluation process in advance, i.e. to define the criteria as well as the procedure for

the later awarding of points – all in the interests of transparency. This then safeguards the credibility and objectivity of the other processes when the subsequent compilation of the data and their processing is carried out by external experts in compliance with the methodology defined by the jury.

Fairness in communication is also an important part of the equation. Black-box approaches merely cloud the issue. The same applies to the tendency of some of the agencies on the market to charge companies, as the “subject of the rating”, for the results of the rating, even though the companies voluntarily make the information available free of charge in the first place. Conditions for establishing quality management on all sides must be built on the transparency of all the methodological steps. In a similar way, sustainable concepts ultimately strengthen the external credibility of the ratings and rankings, as well as the position and public awareness of the companies.

- 2. Dialogue and feedback:** Good sustainability ratings and rankings are feedback-oriented and dialogue-oriented, and harness the competencies of all players. Companies seek dialogue with rating agencies involved, and vice-versa, in every phase of the evaluation process. This is because the mere ex post understanding of the way the rating process took place is just the first step when considering the position of a company in the financial market, and in the mind of the public at large. Valid, reliable, and ultimately, credible rating processes can only be guaranteed when the company can respond to draft ratings produced during the ongoing process, and has time to prepare internal and external positions prior presentations which attract the interest of the media. This also improves the way the ratings and rankings are assessed by the media. Given the plethora of basic questions, this is the optimal way to boost acceptance and quality in the long term, fulfil mutual expectations, and avoid potential frustration. Dialogue here should be understood as a very long-term, and ideally continuous process, with the aim of further developing the investment case as well as the business case of sustainability.

- 3. Process efficiency:** The rating process consists of many different steps which place considerable and diverse practical challenges on the staff as they undertake their day-to-day duties, and which are not only time consuming but also cost intensive. Enquiries and questionnaires submitted to companies come not single spies, but in battalions. Rating and ranking agencies and companies are both advised to use their resources as efficiently as possible. By institutionalising the dialogue process, and by ensuring a high level of transparency and regular feedback, econsense as a business network plays an important role in improving the level of understanding of the work processes involved on both sides. This can improve the mutual flow of information, enhance the efficiency of the work processes involved, and boost the reliability of the results.

- 4. Quality:** The diversity and number of active SRI research, and sustainability rating and ranking agencies reflects the complexity of sustainable development itself. Nevertheless, there is remarkable consistency amongst econsense member companies in pinpointing the best agencies when it comes to quality. The most important criteria here are comprehensibility and transparency. Other parameters are expertise with the selected methodology, and in-depth knowledge of the specific sector by those responsible for undertaking the rating. The econsense network has compiled a wealth of individual experience and sector-specific know-how which can be used to support the continuous exchange of information with rating and ranking agencies.
- 5. Diversity versus standardisation:** The providers of sustainability ratings and rankings position themselves in the market on the basis of their methodology and the focus of their analysis. There are many reasons why approaches based on “standardised research” will continue to be untenable in future for the assessment of sustainable corporate governance. Nevertheless, all of the stakeholders are naturally interested in results which win approval and are comprehensible. We would therefore like to deepen the understanding – for practical and conceptual reasons – of the areas in which standardisation would be feasible and desirable (agreeing on core/key indicators, methods, harmonising criteria, etc.). An important background note here is that standardisation processes already exist in company reporting, and also have an associated impact on rating methods. The financial markets should and will ultimately decide on the standards necessary for ratings.
- 6. Separating rating and consulting services:** Many sustainability rating and ranking agencies also work as management consultants. These functions can be so interwoven that they place at risk, or threaten to jeopardise, the independence and objectivity of these activities.
- 7. Anglo-Saxon and German corporate governance:** The differences between Anglo-Saxon and German business processes or corporate governance continue to fuel debate in the context of sustainability analysis. The questionnaires and surveying methods conceived by analysts with an Anglo-Saxon orientation often fail to honour the differences in governance structures. This can produce conclusions which do not adequately reflect the actual performance of the companies. As multinational companies with a significant presence in the German economy, we wish to play an active role in raising all of the methodological problems, to completely clarify the situation for the benefit of all sides.