Independent Reviews & Reports Regarding SRI Rating Methodologies

SUMMATION

There is increasing conflation with regard to the various definitions given to SRI, RI, Green, Eco and Ethical. Of the 34 SRI based ESG ratings companies there were 34 differing definitions given to these descriptions.

In all cases the ratings companies had not established an overall ESG risk rating methodology but had instead directly applied differing exclusionary filters to unverified information without first establishing an overall agnostic baseline risk value.

Only three research organisations reviewed currently analyze the link between social/environmental issues and material impacts on investment value drivers.

‘Most research methodologies are still primarily generic, that is they are not tailored to address sector-specific issues.’

‘Data is still gathered primarily from the companies themselves or from self-reporting sources such as UNPRI or the UK Financial Stewardship Code with little — if any — verification.’

‘Only one organisation had had its research process and results independently verified.’ (Verification of its own methodologies)

SRI reflects the development of the majority of specialized SRI research organisations which have arisen to service a very specific niche driven by the individual concerns and perspectives of ‘ethical’ investors. However, as the wider Sustainable Development (SD) and Corporate Social Responsibility (CSR) agendas, and ESG, have emerged, mainstream investors have become increasingly interested in a variety of linked concepts (e.g. reputation risks, corporate governance, management quality), but still demand an overall objective ESG risk rating process.

April 2011

According to a study carried out by Dr Jem Bendell who is a Visiting Professor with IE Business School and Associate Professor with Griffith Business School.

The flaws of ESG analysis and ratings need fixing as part of a new attempt to make Socially Responsible Investment funds and self-proclaimed Responsible Investment institutions deliver more for society. After consultations with dozens of reflective practitioners and financial academic critics, the study finds that most SRI based ESG analysts and raters:

• Rely predominantly on information published or provided directly by the companies being assessed, or by media that republish corporate communications. That is problematic because companies with challenging ESG issues are more likely to communicate on these issues, and when they do it is with their particular opinion and choice of issues and data.

• **Are not completely independent from the companies that they are rating**, with a variety of conflicts of interest that need to be managed.

• Focus their analysis on management policies and processes not on the actual ESG impacts and outcomes of the companies assessed. That is problematic because companies with challenging ESG issues are likely to have more developed policies and programmes, but that does not mean they have the least negative or most positive impacts.

• Assess companies within a downside risk framework, focusing on the use of limited frameworks for understanding the complex and evolving field of corporate responsibility, and reductionist methods to assess companies, due to their commercial interests limiting the time, skills and advice available to them. This also means combining issues which perhaps should not be treated equally, and a numerical masking of cultural bias of the analyst organisation and the individual analysts.

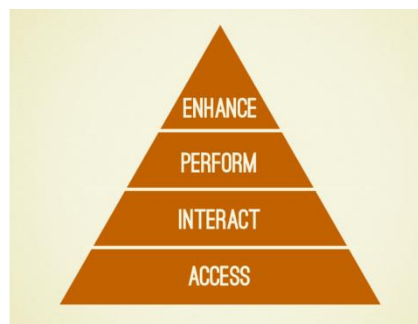
• Conflate the materiality of ESG issues for financial performance of investments and the materiality of those issues to affected stakeholders and wider society. **Some make assessments based on financial materiality and others involve more moral**

judgments. In both cases the credibility and accountability of those judgments are seriously in doubt.

• **Run indices based upon questionable data or supply data to indices that include all forms of enterprise including ones that can never be sustainable (e.g. oil), and thus blur the issue of what is responsible investing for fund managers and private investors, as well as regulators and the wider public.**

• **Do not integrate their ESG analysis products and ratings with the mainstream financial analysis products** and ratings that their own firms or owners offer clients, partly because of a commercial interest in maintaining different products. That is problematic as it restricts the potential to integrate ESG considerations in mainstream financial investment analysis.

• **Are not transparent about their methods of research, analysis, and ranking, or about their general operations, for stakeholders and regulators to assess their credibility in light of the weaknesses described above.**



'The key focus of the review has been on defining SRI/ESG research methodologies that identify, (or not) the material ESG impacts of companies' operations. All reviewed methodologies identified specific sustainability strengths, weaknesses and risks (both generally and to differing degrees sector specific), **but only three had built into their model the link to investment value drivers**. Among the specific value drivers that were identified were shareholder value (which is determined in part as a function of other drivers), revenue, regulatory liability and cost of compliance, operational efficiency, access to capital, customer attraction and retention, brand value and reputation, human and intellectual capital, risk profile, innovation and licence to operate. While linking ESG to value drivers is still unusual in the mainly subjective SRI based rating methodologies, environmental social and governance issues (ESG) has moved further into mainstream business analysis.'

The need to develop criteria and indicators that are relevant and measurable by companies is a key consideration in trying to gain an effective insight into the company's operations and impacts. The growing use of standardised indicators significantly simplifies the task facing companies and research organisations and voluntary disclosure initiatives such as the

GRI reporting guidelines are proving useful, particularly with regard to performance indicators.'

Currently research organisations (ROs) use a wide range of different information sources in order to gain an overall impression of a company's policies, management and performance. These include company disclosure, NGOs, labour organisations, the media, international organisations and guidelines (e.g. the UN), governments, academia and experts/consultants.' **However, unverified company self-reporting was by far the most significant single source of information, accounting for 40—80% of information input.**

'External verification of information was of key importance to ROs. However, the limited availability or nonexistence of verified information means that it is not yet possible to base analysis exclusively on such information.'

'While more than half of the ROs consider company visits a key element in their engagement strategy, time, cost and geographical constraints make systematic visits impossible for the majority of ROs'. The number and intensity of engagements with companies continues to increase in line with the need for a more sophisticated understanding of business processes and strategies. However, **closer relationships also raise concerns that companies may exert undue influence over the outcome of the company's assessment. There does not yet appear to be a satisfactory method to address such conflicts, with some ROs choosing not to engage directly to avoid potential conflicts.**

Only one organisation has currently undertaken an external verification of its research process and results, though SiRi Group members have reviewed each other's processes. SAM Research is the only organisation to employ a third party verifier of its results and processes (Price Waterhouse Coopers). However, this is an 'audit' of its own (SAM) internal methodology which could be in error but would still receive a high audit score if compliant with its own rules.

Verification of published research (i.e. the results of the analysis) is driven by internal systems and checks (**although there is currently a complete absence of a dedicated internal audit function within ROs), their clients and independent committees.**

Need to Seek Certification of Research Process

While none of the SRI/ESG research organisations analysed currently undertake external certification to recognised standards (and only one organisation has verified its processes and results), the debate of **whether any of these entities could build a credible ISO compliant standard intensifies**. Opinion from International Standards experts interviewed highlighted the lack of technical (standards development) experience and the subjective nature of their research methodology on which to base such a standard.

This issue is particularly pertinent for those research organisations that plan to use, or are currently using, more sophisticated assessment techniques that seek to link ESG issues to investment value drivers. Clearly there is a delicate balance here between keeping commercially sensitive elements of the research process confidential, while also ensuring that the methodology as a whole is robust (and is seen to be robust) and transparent in applying stated research goals and processes effectively and consistently. Nonetheless ROs can agree with verifiers that certain elements of the research process need not be detailed, but can still verify that the models and processes exist and do what they set out to do, without revealing the intrinsic elements of the models. The costs involved in such external audits — and who pays — is still an open issue.

Currently the proportion of analysts with financial experience within research teams is very low and the **presence of team members with any kind of standards experience totally nonexistent. Of 150 Investment Managers and ESG research organisations interviewed, fewer than 2% were able to distinguish between, what constitutes a 'standard' and the differentials between a standard and voluntary codes of practice, protocols, stewardship codes and 'best practice'. Of the 150 interviewed none were able to define the exact meanings attached to the words, Green, Eco, SRI, RI and Ethical**.

As research organisations continue to focus on sector specific issues and risks, the need for more in-depth understanding of how business operates in different sectors will be crucial. Analysts with experience in large cap companies will be of particular importance.

One of the key issues companies have raised with SRI/ESG analysis is the RO's lack of understanding of their unique business issues and impacts. Currently the proportion of analysts with business experience within research teams is also low; many RO's offer a range of other services to companies. Offering services to companies raises the issue of potential conflicts of interest, in particular with respect to solicited ratings, assessments and consulting which lead to the circularity much present in the sub-prime crisis whereby, the rankings depend upon the ratings and the ratings depend upon the paid for rankings.

Need for More Regular & Advanced Monitoring Techniques

Currently the most common tool for monitoring is through media updates. However, some stakeholder voices are not well represented within the mainstream media, in particular NGOs in emerging economies. Increasingly innovative monitoring systems will be required therefore to address these communities better and to identify current and emerging issues from a range of stakeholders and sources, in a timely and efficient manner.

HOW DO COMPANIES IDENTIFY THEIR MATERIAL ISSUES AND WHAT ARE THEY? ARE LINKS TO VALUE CREATION BEING MADE?

Material sustainability issues are currently identified through internal ad hoc processes, but supplemented by media monitoring which was seen as a useful early warning system for issue identification.

Research Methodology

One comment often raised by companies is that many SRI/ESG research organisations do not understand their businesses (in terms of how they operate) and that the methodologies are not focusing on key company and sector specific issues. 'SRI analysts are faced with growing complexity in the sustainability agenda as well as an increasing range of issues.' '**The majority [of RO's] still focus on negative** and best-in-class screening models which, although serving current niche ethical investors well, do not meet the needs of more mainstream investors.' External verification of data is still a significant challenge for RO's who often rely on the media to cross-check and validate the veracity of data. In addition, wider sources of information of a financial and strategic nature are still unavailable to many of the organisations, reducing their ability to identify issues related to investment value creation.

While a whole variety of factors is important in assessing the quality of research teams, a key part is dependent on the size and experience of the team. Of the ROs reviewed, there was an enormous variety in these parameters with teams ranging in size from six to forty full-time equivalents. There was also significant variation in the levels and types of experience of the analysts with particularly low levels of experience in financial qualifications and in large cap experience. Furthermore, there was also huge variation in the numbers of companies analysed per year by each analyst, with figures ranging from 25 to 100 companies per year.

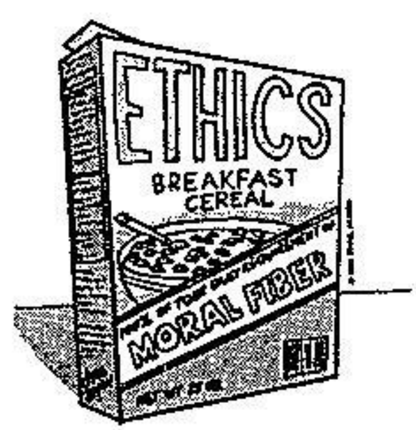
Research Teams

'While the range of client services appears to be reasonably good, some outstanding issues with regard to quality still remain. **These include questions of potential conflicts of interest between consulting services and ratings**, the quality of monitoring services (e.g. frequency) and the accessibility of research reports. Companies are often no better able to identify the material sustainability issues facing them than are SRI/ESG RO's. While several issues in different industry sectors were highlighted, these were based almost exclusively on anecdotal and qualitative information.

New Economics Foundation

An Ethical Door Policy: How to avoid the erosion of ethics in Socially Responsible Investing

Marketing yourself as ethical is a volatile and risky business unless you can substantiate the integrity of what you do. This is a 'prove it' world. Modern SRI/ESG retail fund managers typically manage their portfolio through a combination of basic screening requirements, positive and negative, and engagement strategies. But throughout the SRI/ESG range, there currently lacks any well developed framework for comparison for companies between SRI products, business sectors or transnational same sector comparison.



The Ethical Investors Group, for example, ranks a selection of SRI funds on the quality of their ethical criteria. The funds that score poorly include City Financial, Framlington Health

Fund and Sovereign Ethical Fund. Other funds, such as the Standard Life Ethical Fund are heavily focused on the environment, engaging only on a superficial level with regards to human rights of labour issues. Without specialist knowledge, it remains far more difficult for the consumer to distinguish between SRI/ESG funds on grounds of ethical performance than on the basis of historical financial performance, which is one of the driving forces behind ethical investment.

'Many firms have adopted some of the relevant CSR management techniques, making them eligible for inclusion in various SRI/ESG categories, but information is lacking on whether or not social and environmental performance has, in fact, been altered.'

The process-driven approach leads the SRI/ESG community towards a 'moral drift', accepting investments that fit a given criteria but without an entry-level barrier with regards to ethical performance. Ironically, **those companies which have avidly adopted the CSR agenda are often amongst the most 'unethical' companies (e.g. Shell, BP and RTZ).** As CSR management practices have been adopted, they are attractive to the SRI investor. While SRI funds have typically avoided these companies, they have nonetheless been rewarded by the headline SRI indices, such as FTSE4Good. Over time their performance may improve**, but even the 'best of the class' of the oil companies ought to be excluded from SRI categories concerned with the environment, if their core activities continue to support a primary market failure which is the lack of accounting for the true social and financial cost of carbon emissions.**

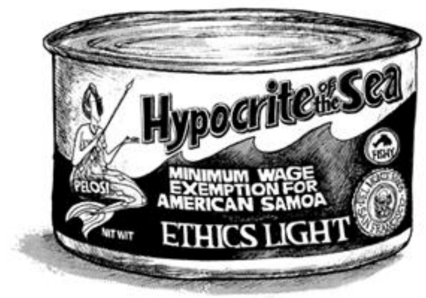
Note: By definition SRI Ratings Agencies should exclude oil companies; however, this sector represents a major fee generator for the SRI Industry.

Typically, however, SRI/ESG funds claim legitimacy by appointing 'committees of reference' or using name brand 'consultants' to do screening**. Neither is an effective route to raising quality. As of now, SRI/ESG research screening is a consultancy business, subject to the usual conflicts of interest, rather than a profession governed by definable standards.**

Ethics itself is a loose term. **With no baseline standards, there are opportunities to manipulate the definition of ethics in order to incorporate some high performing companies with questionable track records. The weakening of ethical criteria may be less the case within many retail SRI funds, but is clear cut for a number of the**

recently developed SRI/ESG/Sustainability indices. As ethical investment pioneer Tessa Tennant argues in the Financial Times, “simply declaring a company best-in-class can also be a means of justifying stock selection that would otherwise have no place in a SRI portfolio”

‘As these indices spawn new SRI savings products, so a new generation of ‘ethics lite’ - high claim / low ethics - SRI funds will be born. In the case of the FTSE4Good, for example, only so-called “high impact” companies are scrutinised, and only in particular areas. Thus, IT companies are not considered to pose a risk to the environment, in spite of the use of energy that consumer IT and electrical goods consumes and the problem with disposal of IT hardware equipment.’



COMPARING THE SRI INDICES TOP 10

Index Ethical Approach

Top 10 Companies in index by Market Cap:

- Data collection from companies and government information
- Contacts with special interest groups
- Microsoft Corporation
- American International GP
- Intel Corporation
- Merck & Co. Inc.
- AOL Time Warner, Inc.
- SBC Communications Inc.
- Verizon Communications
- Johnson & Johnson
- Cisco Systems Inc.
- Coca-Cola Company

Dow Jones Sustainability Index

Excludes some industries:

Remainder based primarily on questionnaire input and review of existing policies and reportsMyers Squibb GlaxoSmithKline PLC Home Depot Inc. Intel Corp. Johnson & Johnson Novartis AG Pfizer Inc. Procter & Gamble Co Royal Dutch Petroleum Co.

FTSE4Good (UK 100)

Excludes key industries:

- Screening "high impact companies" only
- Best practice approach
- Limited measures of performance
- GlaxoSmith Kline
- Vodafone
- HSBC
- AstraZeneca
- Shell Transport & Trading
- Lloyds TSB
- BT
- Barlcays
- Diageo

The Dow Jones Sustainability Index includes companies that may be making efforts to clean up their act but still operating in ways far from the dictates of sustainability, (i.e. in terms of full-cost accounting and the maintenance of natural resources over generations). When dealing with long-term issues of survival, **being semi-sustainable is not enough. From this perspective, the Dow Jones Index is closer to being an 'Unsustainability Index'.** Excluding companies that are unreconstructed even in terms of the first steps forward is not enough to warrant a badge of sustainability for those left in. Increasingly, some Technical Standard Developers are warning against the perceived stored up risk elements endemic within SRI based, (non-sustainability based) ESG Ratings, this due to their historic ratings methodologies which are unable to predict risk only report some 18 months after the event. One such research facility predicts major shareholder losses in at least one (and possibly three) of the large Multinationals currently featuring in all the SRI based ESG Ratings Agencies 'Top Ten' ESG performers.

There are some obvious 'rotten eggs', or perhaps more fairly 'over-hyped' SRI initiatives. It could be argued that these are not the market leaders and that there are good counter-examples of excellence emerging. But this does not seem convincing as a strategic view. It ignores the extent to which the **sector overall can be increasingly tainted and**

discredited by poor performers that trade on ethics but are cheapening standards. It undermines the long-term credibility of SRI/ESG. An industry born out of a consumer demand to know how funds are being used, cannot afford to see trust eroded by misleading claims or poor quality (Greenwash). **Trust is self-reinforcing: trust breeds trust but mistrust breeds mistrust.**

There is logic in a system in which ethical funds should be required to meet a minimum baseline standard. Most importantly, funds should themselves have to meet the ethical performance criteria they set out in defining themselves as 'ethical'.

The strategic view of early pioneers of organics, who included visionary economists such as Fritz Schumacher and George McRobie, was that even if it took time, the organic approach was bound to succeed. It was the only way to approach environmental sustainability. Their concern was to secure the integrity of the approach against being watered down even if it raised costs and created barriers to entry into organics markets. An organics standard and certification approach pioneered by Edwin Aalders and Chris Yates-Smith under the rubric of SGS was how they achieved this.

It could be argued that the absence of standards encourages funds to compete with each other on the quality of their ethics in order to differentiate what they do. But in practice, this is not what is happening, especially given limited public awareness of the diversity of approaches available. This could be explained if new funds were appealing to new investors rather than predominantly competing for existing investors. **For this, all they need to do is to claim the badge of being an 'ethical investment'. Indeed, by paying a small fee to the UK Social Investment Forum, they are able to use the only recognised logo in the field in their advertising. In reality, the claim to be 'a member of the UK Social Investment Forum' means nothing more than a rhetorical commitment to 'advance' SRI/ESG, with none of the real quality testing and certification that occurs with the use of programs such as the SGS Global Organic Logo and certification standard. The Social Investment Forum has no teeth with which to raise quality standards and the only power it does have, to revoke organisational membership, has never been used.**

The core requirement to ensure baseline quality across the field is therefore based on the principle of accountability via a recognised standard, testing and certification. Information systems should rely on data from a range of credible sources – not just from inside the company. European governments such as the UK and Germany are taking an active interest in the development of the SRI/ESG sector. **If the evolution of baseline standards does not evolve initially within a market-environment through self-selection and certification, as in the SGS model, then government will ultimately have to step in and impose a standard**.

The growth of SRI/ESG and innovations that have taken place in the sector, has risked sowing the seeds of its own downfall by diluting quality standards. Without such standards, the new SRI/ESG Indices in particular will represent cuckoos in the nest. With quality standards they can begin to play the role needed of differentiating between companies in terms of progress towards good practice without diluting what counts as good practice.

Moreover, some SRI/ESG funds are proving less than transparent in terms of living up to their own criteria for investment in other companies. **A time of growth is a good opportunity to invest in the next round of innovation and development required to sustain success. While developing and instituting a standard will not be straightforward, the alternative of a downward slide into scandal and consumer mistrust will be tougher.**