

## Integrating ESG into investments and stewardship



# Overview

There is a growing demand for Environmental, Social and Governance (ESG) factors to be incorporated into investment decision making and stewardship. The FTSE ESG Ratings provide objective ESG exposure and performance data that is based on clear and easy to apply methodologies.

## **This document:**

- (i) Summarises the FTSE ESG Ratings methodology, which is used to compile the ESG Ratings and as the engine driving the selection of constituents for the FTSE4Good Index Series.
- (ii) Provides an overview of the range of ways that investors can and are using this data to inform investment decision making and stewardship.

The model consists of three pillars; Environment, Social and Governance. These Pillars are divided into fourteen Themes which are applied to a large global universe of stocks applying the methodology set out here to produce ESG Scores and Ratings.

The FTSE ESG Ratings comprise of an overall ESG Rating that breaks down into underlying Pillar and Thematic Scores that themselves are built on more detailed indicator assessments which allow investors to understand a company's ESG practices in multiple dimensions.

## FTSE ESG Ratings: Data Structure Overview

Data is compiled at four hierarchical levels, for each stock this allows for;

Data hierarchy	Score assessment	Exposure assessment	Data range
<b>Top Level</b>	<b>1 ESG Rating</b>		Absolute ESG Rating: 0-5 to 1 decimal point ESG Supersector relative ESG Rating: 1-100 percentile
<b>Second Level</b>	<b>3 Pillar Scores</b> Environmental, Social, Governance	3 Pillar Exposures Measures the relevance of each of the 3 Pillars to each company	Absolute ESG Pillar Score: 0-5 to 1 decimal point Absolute ESG Pillar Exposure: 0-5 to 1 decimal point ESG Supersector relative ESG Pillar Score: 1-10 decile
<b>Third Level</b>	<b>14 Theme Scores</b> e.g. Anti-Corruption, Climate Change, Health & Safety	14 Theme Exposures Measures the relevance of each of the 14 Themes to each company	Absolute ESG Theme Score: 0-5 to 1 decimal point Absolute ESG Theme Exposure: 0-5 to 1 decimal point
<b>Fourth Level</b>	<b>350 Indicators</b> Typically 10-35 per Theme An average of ~ 125 indicators apply per company	<i>Indicator applicability is relative to Theme Exposure</i>	Points assigned per indicator met

### Score Assessments: measuring practice and performance

A diverse range of indicators are employed to tailor for all areas of a given Theme. These cover (i) qualitative indicators assessing quality of management and approach, (ii) quantitative indicators measuring corporate data disclosure, (iii) sector specific indicators tailored for different industrial sectors and (iv) performance indicators that use the quantitative data to make performance judgements.

The FTSE ESG Model is under constant review and will be updated on an annual basis.

### Exposure Assessments: measuring relevance and materiality

The Exposure is measured primarily through (a) the ICB Subsectors where a company is active and (b) its presence in specific countries. The specific Subsectors and countries which are applicable varies by Theme. All the Theme Exposures are determined using a rules based methodology that is derived from publically available information and data sources. For Exposure each company is categorised as High, Medium, Low or Not Applicable for each of the 14 Themes.

# FTSE ESG Indicator Table – High Level Summary

	Strategy and Practice	Quantitive, Sector Specific and Performance
<b>Climate Change</b>	<ul style="list-style-type: none"> <li>GHG* emissions and energy reduction</li> <li>Collaborative initiatives</li> <li>Board oversight</li> <li>Short-term quantitative targets</li> <li>Long-term quantitative targets</li> <li>Adaptation to physical impacts</li> <li>Quantified progress against targets</li> <li>Financial quantification of costs and R&amp;D</li> <li>Independent verification of GHG or energy</li> <li>Intensity of GHG emissions reported</li> </ul>	<ul style="list-style-type: none"> <li>Targets to reduce fleet GHG emissions</li> <li>Progress against targets on product GHG</li> <li>GHG emissions per unit of revenue</li> <li>GHG emissions per MWh produced</li> <li>Coal reserves per unit revenue</li> <li>Total energy consumption</li> <li>Disclosure of oil and gas reserves</li> <li>Fleet fuel efficiency by country/region</li> </ul>
<b>Water Use</b>	<ul style="list-style-type: none"> <li>Policy commitment to address water use</li> <li>Risk assessment in water stressed regions</li> <li>Actions taken to reduce water use</li> <li>Quantified progress against targets</li> <li>Independent verification</li> <li>Collaboration with others on efficient water usage</li> </ul>	<ul style="list-style-type: none"> <li>Total water usage</li> <li>Percentage of water recycled</li> <li>Quantified water usage targets</li> </ul>
<b>Biodiversity</b>	<ul style="list-style-type: none"> <li>Policy commitment on biodiversity</li> <li>Commitment to net positive biodiversity impact</li> <li>Biodiversity targets</li> <li>Assessment of biodiversity risks</li> <li>Biodiverse habitats near operations, or restored</li> <li>Biodiversity Action Plans (BAPs) and audits</li> <li>Participation in biodiversity certification schemes</li> </ul>	<ul style="list-style-type: none"> <li>Commitment to rehabilitation of mining sites</li> <li>Round Table for Sustainable Palm Oil (RSPO)</li> <li>Percentage certifications for palm oil</li> <li>Percentage certifications for forest products</li> <li>Percentage certifications for responsible/sustainable seafood</li> </ul>
<b>Pollution &amp; Resources</b>	<ul style="list-style-type: none"> <li>Policy to reduce pollution, waste, resources</li> <li>Targets to reduce pollution, waste, resources</li> <li>Progress on targets for pollution, waste and resources</li> <li>Quantified water discharge and resource use</li> <li>Independent verification</li> <li>Financial quantification of costs and R&amp;D</li> <li>Life cycle assessments and industrial ecology</li> </ul>	<ul style="list-style-type: none"> <li>NOx and SOx emissions</li> <li>Volatile Organic Compounds</li> <li>Recycled and non-recycled waste</li> <li>Cost of environmental fines and penalties</li> <li>Percentage of sites covered by ISO14001 or EMAS*</li> </ul>
<b>Environmental Supply Chain</b>	<ul style="list-style-type: none"> <li>Policy addresses energy use and GHG emissions</li> <li>Policy addresses water use and biodiversity</li> <li>Policy addresses environmental issues and pollution</li> <li>Policy addresses waste and resources</li> <li>Risk assessment and due diligence</li> <li>Monitoring including audits and results</li> <li>Communication and training of suppliers</li> <li>Encourage suppliers to reduce and report</li> </ul>	<ul style="list-style-type: none"> <li>Property portfolio policy on environmental issues</li> <li>Property portfolio targets on GHG, energy, water use</li> <li>Certification to a building management standard</li> <li>“Green leases” for tenants of property portfolio</li> <li>Building management systems, smart meters, biodiversity</li> <li>Aggregate GHG emissions on properties</li> <li>Aggregate energy data on properties</li> <li>Aggregate water usage data on properties</li> </ul>
<b>Health &amp; Safety</b>	<ul style="list-style-type: none"> <li>Policy addresses health &amp; safety and contractors</li> <li>Commitment to continuous improvement</li> <li>Targets to reduce incidents</li> <li>Board oversight and presence of H&amp;S Committee</li> <li>Address global health (HIV/AIDS, malaria, TB)</li> <li>Performance and progress against targets</li> <li>Risk assessment and due diligence</li> <li>Employee involvement in improvements</li> <li>Performance monitoring and management</li> <li>Incidents investigated, reported and action taken</li> <li>Independent verification</li> <li>Programme for a global health issue</li> </ul>	<ul style="list-style-type: none"> <li>Policy and procedures for unplanned plant shut-downs</li> <li>Policy and procedures for radiation incidents and events</li> <li>Policy and procedures for radiation hazard assessment</li> <li>Policy and procedures for radiation to employees and community</li> <li>Policy and procedures radioactive waste</li> <li>Work-related fatalities over 3 years per 1000 employees</li> <li>Percentage of sites with OSHAS* 18001 certification</li> <li>Number of staff trained on health and safety standards</li> <li>Lost time incident rate over last 3 years</li> <li>Number of unplanned plant shut downs over 3 years</li> <li>Number of incidents on IAEA INES* event scale</li> <li>Total weight/volume of radioactive waste over 3 years</li> <li>Radiation exposure for community and employees over 3 years</li> </ul>
<b>Labour Standards</b>	<ul style="list-style-type: none"> <li>Policy addresses core ILO* conventions</li> <li>Policy addresses non-discrimination</li> <li>Policy addresses working hours and living wage</li> <li>Commitment to frameworks on labour standards</li> <li>Policy on under-privileged and youth unemployment</li> <li>Policy translated and communicated</li> <li>Risk assessment and due diligence</li> <li>Actions to address labour issues and improve diversity</li> <li>Incidents of non-compliance and action taken</li> </ul>	<ul style="list-style-type: none"> <li>Black Economic Empowerment</li> <li>Full time staff voluntary turnover rates</li> <li>Percentage of employees that are contractors or temporary</li> <li>Amount of time spent on employee development training</li> </ul>

\*GHG Greenhouse Gasses; EMAS Eco-Management and Audit Scheme; OSHAS Occupational Health and Safety Advisory Services; IAEA International Atomic Energy Agency; INES International Nuclear and Radiological Event Scale; ILO International Labour Organisation

	Strategy and Practice	Quantitative, Sector Specific and Performance
<b>Human Rights &amp; Community Indicators</b>	<ul style="list-style-type: none"> <li>Support for international standards</li> <li>UN Guiding Principles on Business and Human Rights</li> <li>Children's Rights and the Business Principles</li> <li>Commitment to local employment</li> <li>Impact assessment on new and existing operations</li> <li>Stakeholder engagement consultations and reports</li> <li>Grievance mechanisms in place</li> <li>Disclosure of human rights incidents and actions</li> <li>Participation in external schemes</li> <li>Output of community investments quantified</li> </ul>	<ul style="list-style-type: none"> <li>Policy addresses freedom of expression</li> <li>Policy addresses data privacy</li> <li>Policy/Principle/Code on indigenous rights</li> <li>Policy addresses security guard issues</li> <li>Donations/community investments made to not-for-profit organisations</li> </ul>
<b>Customer Responsibility</b>	<ul style="list-style-type: none"> <li>Responsible advertising and marketing</li> <li>Policy on negative impact on customers</li> <li>Membership of industry initiatives or use of Codes Guidelines and training</li> <li>Vulnerable groups or their issues recognised</li> <li>Initiatives to protect vulnerable groups</li> <li>Research and development</li> </ul>	<ul style="list-style-type: none"> <li>Responsible selling for client-facing sales staff</li> <li>Access to medicine strategy and programmes</li> <li>Access to nutrition strategy and programmes</li> <li>Adoption and adherence to WHO* Code on Infant Formula</li> <li>Non-compliance and corrective action on BMS* marketing</li> <li>Verification and reporting on marketing of BMS</li> </ul>
<b>Social Supply Chain</b>	<ul style="list-style-type: none"> <li>Policy addresses the core ILO Conventions</li> <li>Policy addresses working hours and living wage</li> <li>Policy addresses health and safety</li> <li>Policy translated and communicated</li> <li>Risk assessment on new and existing suppliers</li> <li>Results of supplier monitoring/auditing</li> <li>Policy integrated into buyer training and purchasing</li> <li>Capacity building in suppliers</li> <li>Member of recognised supply chain initiative</li> </ul>	<ul style="list-style-type: none"> <li>Property policy on social issues and community engagement</li> <li>Property accessibility: disabled persons, also public transport</li> <li>Signatory and reporting to UN PRI*</li> <li>ESG integration into investment, and long term investment</li> <li>Engagement with companies in portfolio on ESG issues</li> <li>Signatory and reporting to Principles for Responsible Insurance</li> <li>ESG integration into insurance process</li> <li>Signatory to UN SSEI (Sustainable Stock Exchange Initiative)</li> <li>Support ESG products, and guidance for issuers on ESG disclosure</li> <li>Member of and reporting to the Equator Principles</li> <li>ESG integrated into lending policies and strategies</li> <li>Results of supplier monitoring/auditing and actions on non-compliance</li> </ul>
<b>Anti-Corruption</b>	<ul style="list-style-type: none"> <li>Policy addressing countering bribery</li> <li>Policy addressing anti-corruption</li> <li>Board oversight of anti-corruption policy</li> <li>Risk assessment of operations and intermediaries</li> <li>Due diligence of new business partners</li> <li>Whistle-blowing mechanism in place</li> <li>Communication and training</li> <li>Procedures for high risk operations</li> </ul>	<ul style="list-style-type: none"> <li>Political contributions made</li> <li>Number of staff dismissals due to non-compliance with anti-corruption policy</li> <li>Cost of fines, penalties, settlements in relation to corruption</li> </ul>
<b>Tax Transparency</b>	<ul style="list-style-type: none"> <li>Policy commitment to tax transparency</li> <li>Align tax payments with revenue generating activity</li> <li>Tax policy oversight by Board</li> <li>Public statements on tax transparency by CEO/CFO</li> </ul>	<ul style="list-style-type: none"> <li>Verification of tax data</li> <li>Disclosure of corporation tax paid globally</li> </ul>
<b>Risk Management</b>	<ul style="list-style-type: none"> <li>Code of Conduct</li> <li>Risk management framework</li> <li>Reference to external standards</li> <li>Board oversight over Code and risk management</li> <li>Whistle-blowing mechanism in place</li> <li>Non-compliance procedures and reporting</li> <li>Reviews of Code compliance against Code of Conduct</li> <li>Committee or senior executive responsible for risk</li> <li>Scenario planning and stress testing</li> <li>Response plans and emergency procedures</li> </ul>	<ul style="list-style-type: none"> <li>Legal and compliance leads have Board access</li> <li>Board oversees risk management</li> <li>Non executive board risk management expertise</li> <li>Repeated fines/settlements &gt;\$100m</li> <li>BIS* Tier 1 Capital Ratio</li> <li>BIS Core Tier 1 Capital Ratio</li> <li>Leverage Ratio (Tier 1 Capital to Total Exposures)</li> <li>Liquidity coverage Ratio (LCR)</li> <li>Provisions for fines and settlements in audited accounts</li> </ul>
<b>Corporate Governance</b>	<ul style="list-style-type: none"> <li>Separate chairman and CEO</li> <li>Details of Directors expertise and experience</li> <li>Commitment to diversity on the Board</li> <li>Board meeting frequency and attendance rate</li> <li>Committee and Charter for remuneration</li> <li>Remuneration has long-term mechanisms and ESG</li> <li>Disclosure fixed and variable remuneration</li> <li>Disclosure of fees paid to auditors</li> <li>Shareholder voting rights</li> <li>Provisions to protect minority shareholders</li> <li>Disclosure of voting results</li> </ul>	<ul style="list-style-type: none"> <li>Part of variable remuneration deferred for 3 years or more</li> <li>Claw-back or malus exists for remuneration</li> <li>Bonuses are capped at a particular % of salary</li> <li>Variable compensation considers performance relative to risk</li> <li>Percentage of Independent Directors on the board</li> <li>Percentage of women on the Board</li> <li>Number of days before AGM agenda published</li> <li>Maximum number of years for which executive remuneration is deferred</li> <li>Percentage executive remuneration deferred</li> <li>Percentage of executive salary to which bonuses are restricted</li> <li>Percentage of salary of other staff to which bonuses are restricted</li> </ul>

\*WHO World Health Organisation; BMS Breast Milk Substitutes; UN PRI United Nations Principles for Responsible Investment; BIS Bank for International Settlements

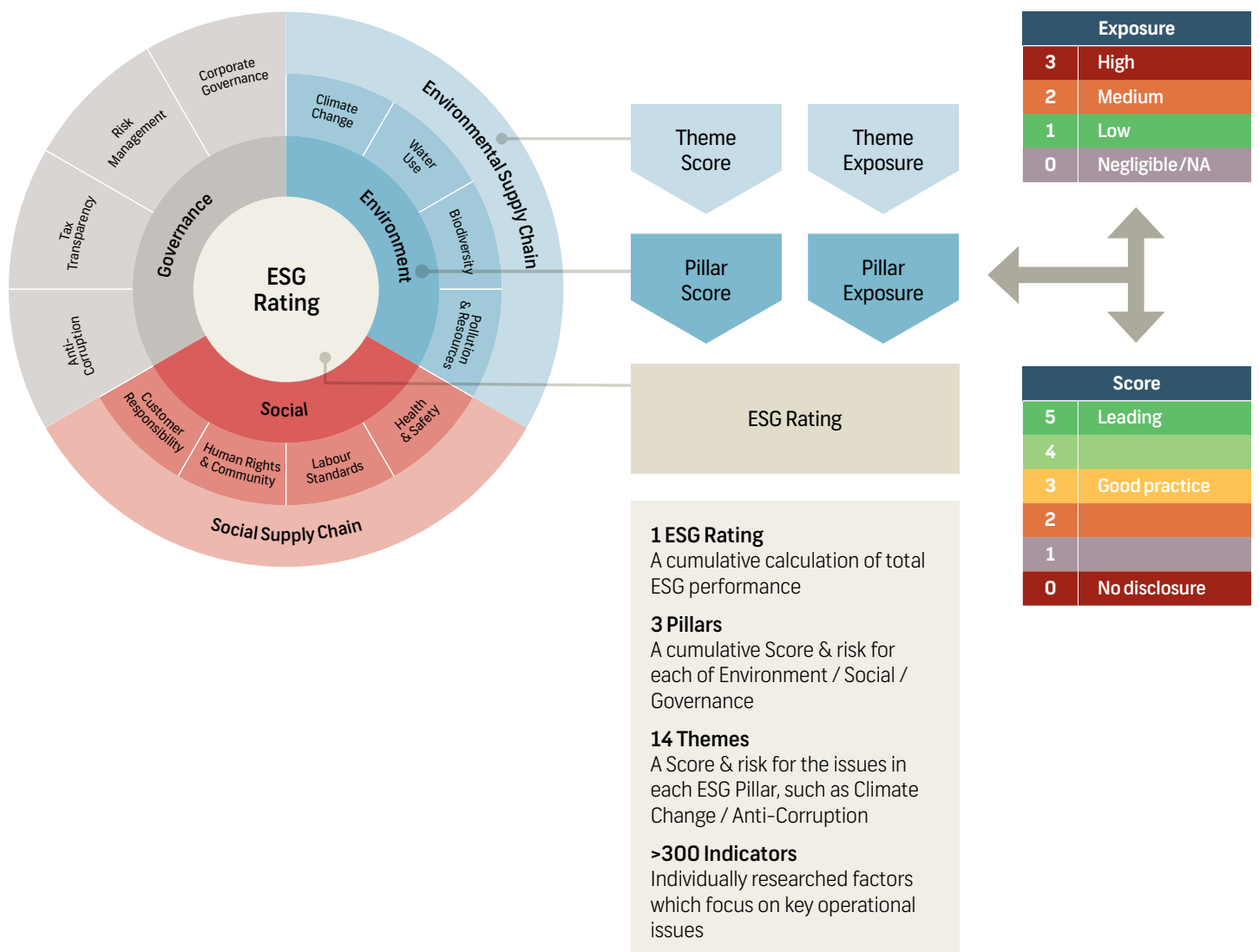
# Key Features

- **Flexibility and Customisation:** The design of the system is to allow clients the ability to extract data at multiple levels in order to assess and apply it in a variety of ways. Some components will be more and less valuable to different users of the data so it is designed to be easily sliced and diced.
- **Materiality: Exposure Relative Scoring.** Higher exposure companies are assessed using tougher standards than lower exposure companies. More indicators apply to higher Exposure companies and the Theme scores are derived using threshold bands which are calibrated higher for companies with a higher exposure. Furthermore, the calculation of Pillar Scores and overall ESG Ratings are not a simple mean average of all the Theme Scores, instead a weighted average is calculated whereby each Theme is weighted by its Exposure Level; Low Exposure has a weight of 1, Medium Exposure a weight of 2, High Exposure a Weight of 3 and for some Themes companies will not be assessed and hence categorised as “Not Applicable”.
- **Industry relative Ratings and Scores.** These are calculated by comparing a company’ s Score or Rating to others within the same ICB Supersector. This provides scores in deciles for Pillars and percentiles for the overall ESG Ratings. For example, for the overall ESG Ratings, a “1” means a company is in the bottom 1% and “100” means a company is in the top 1%.
- **Focus on relevance, performance and outcomes.** Over 100 indicators are sector specific and a further 60 are quantitative or performance indicators.
- **Taking transparency and governance further.** The criteria are based only on publicly available data, and in assessing ESG practice FTSE does not accept data or information privately provided by companies. This improves the credibility of data and enhances transparency across the market. The FTSE ESG Ratings also fall under the oversight of an independent committee comprising experts from the investment community, companies, NGOs, unions and academia. They meet regularly to oversee ESG Rating reviews and methodology development.



# The FTSE ESG Ratings model

The FTSE ESG Ratings use a company's Theme Exposure and Theme level score assessment to calculate a range of assessments that allow investors to understand a company's ESG practices in multiple dimensions.



## Using FTSE ESG Ratings in practice

The FTSE ESG Ratings offer an objective and flexible service integrating ESG considerations into investments and stewardship approaches. The FTSE ESG Ratings can be used in a variety of ways, building a basis for active portfolio management, company engagement, customised indices, ESG risk analysis or research and analysis.

### Manager selection and evaluation.

When selecting and evaluation asset managers, institutional investors are increasingly assessing how far they integrate ESG factors into their processes. The FTSE ESG Ratings can help you assess the range, average and variance of asset manager portfolios against ESG themes, and their exposure to different ESG exposures.

#### *Example*

The ratings reveal a portfolio manager's exposure to companies with poor anti-corruption scores. This allows the asset owner to raise a concern with their asset manager.

### Engagement and stewardship.

As part of their stewardship responsibilities, an increasing number of fund managers and pension funds are engaging investee companies regarding their ESG practices. The FTSE ESG Ratings provide an independent and objective measure to identify companies for engagement and track progress.

#### *Example*

Identifying high-exposure companies with low scores on labour standards as priority engagement.

### Exposure management.

The ratings enable you to identify where the greatest ESG exposures exist in a portfolio by revealing securities with the highest exposures and poorest scores. Through these insights, you may wish to analyse the securities further, engage with the companies, or exclude them from the portfolio. You can also use the ratings alongside conventional exposure analysis to provide a complementary perspective on risk.

### Research and analysis.

When identifying and measuring the risk and return relationships of different ESG factors, the FTSE ESG Ratings provide a comprehensive data set for research and analysis.

### Custom solutions.

The ratings allow you to create indices by theme, pillar, geography, score, exposure impact, or any combination of these, according to investor needs. Additionally, they help you create quantitative ESG indices, such as a customised weighted index bases on a particular ESG exposure factor. ESG factors can also be used alongside fundamental or risk efficient methodologies.

#### *Example*

A client wishes to use a fundamentally weighted index that includes climate change scores as an additional factor.

### Active portfolio management.

You may use the scores to define an eligible investment universe or apply the data into a propriety quant or fundamental model.

#### *Example 1*

Defining an investment universe limited to companies achieving high scores in environment management and achieving moderate scores in other themes.

#### *Example 2*

Including the Human Rights and Community score within an inhouse security evaluation model to determine a buy, hold or sell decision.



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FTSE is a pioneer in responsible investment. For over a decade, we have calculated responsible investment indices and play active roles in all the major regional sustainable investment industry associations. As a founding signatory, we also helped develop the United Nations-backed Principles on Responsible Investment (PRI).

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