



# Inrate's ESG Impact Rating Methodology

## Countries / Sovereign Bonds

Inrate

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## 1 Background and objective

The role of the state is crucial in shaping activities of individuals and companies within their territorial boundaries on a national level as well as on an international level. By defining laws, setting regulations, and by implementing policies and programs they set a general framework which can either favor or hamper sustainable development.

The Inrate Country rating aims at supporting investors in assessing the impact of states by facilitating the sustainability measurement of governmental bonds. The method and calculation of the sustainability impact of states is adapted to the function and role of states regarding sustainable development. The Inrate Country Rating methodology thereby goes beyond traditional country rating approaches. Due to the crucial role of states in shaping a sustainable development, Inrate has identified the assessment of states based on ESG criteria as an integral part of our sustainability analysis. The rating methodology therefore focuses on aspects which states have a direct influence on or where they function as main actors and thereby avoids the assessment of a country's risk exposure or preconditions due to its development status or geographical location.

## 2 States and sustainable development

States are entities, which organize how their population lives together within their territorial boundaries and beyond. State entities have different facets, ranging from a geographical perspective, a demographic perspective to an institutional and political perspective. The influence of the state is encompassed by providing the basic framework conditions and to organize society and the economy comprehensively.

### 2.1 Contribution of a state to sustainable development

State institutions and state actors have different roles to play and different possibilities or opportunities to contribute to sustainable development. The main **roles of a state** can be summarized as follows. In all these functions, states take decisions that can either favor or hinder a sustainable development.

- Legislator: Setting legislation, delineation of citizenship rights and duties.
- Regulator: Setting regulations that provide framework conditions e.g. for the economy, actions of individuals and legal persons.
- Law enforcer: Enforcing a set of rules, principles, or laws and uphold the rule of law.
- Provider of basic services such as health services, education, basic infrastructure (incl. running of infrastructure), etc.
- Public expenditure: Supporting and incentivizing activities such as social welfare benefits, state programs or activities for incentive desired activities. This role is close to the state's role of providing basic services (both have financial implications).
- Principle actor: in cases where state-owned enterprises or state actors are directly engaged (negative examples are corruption, violations of human rights by state actors, etc.)
- International actor: Abidance to international law, fulfilment of international commitments, cooperation with other states, collaboration in framing international order / legislation as a member of the international community.

## 2.2 Main aims and principles of a state

The constitution of a state generally defines the main aims and principles of how its citizens live together. These could encompass the following elements<sup>1</sup>:

- Protect the life, liberty and rights of the people (fundamental rights and political rights), including the protection of physical conditions.
- Safeguard the independence and security of the country and the protection of population.
- Promote the common welfare:
  - Ensure social security, access to health services, fair working conditions as well as quality of and access to education.
  - Establish framework conditions for the economy that contribute to welfare, economic security and financial stability.
- Provide basic public infrastructure such as energy infrastructure, water and sanitation, transport infrastructure.
- Promote sustainable development and be committed to the long-term preservation of natural resources: Endeavour a balanced and sustainable relationship between nature and its capacity to renew itself and the demands placed on it by the population.
- Promote internal cohesion and cultural diversity of the country.
- Ensure greatest possible equality of opportunity among its citizens.
- Be committed to a just and peaceful international order.

In general terms, Inrate's assessment of states is based on the following general principle: States contributing most to a sustainable development are states which best protect and favor fundamental rights and aims, which are liberty and rights of people, peace, security, stability, welfare, justice, cohesion, preservation of livelihood and natural resources.

## 3 Methodological principles of the Inrate Country Rating

The following principles are defined for developing the rating methodology:

The **environmental or social performance** of a state (e.g. in terms of quality of life, etc.) is considered whenever there is a predominant role of the state for reaching a level compatible with sustainable development. Indicators which are primarily influenced by actions of individuals or companies are not considered.

The **rating methodology focuses on sustainable development** of states and in this respect on aspects on which states have a direct influence (e.g. as a legislator, regulator etc.), or where they are the main actors. These are mainly aspects such as institutional capacities, political programs, regulatory frameworks and law enforcement. The rating tries to avoid the assessment of a country's risk exposure or preconditions due to its development status or geographical location. However,

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<sup>1</sup> based on the aim and chapters of the Federal Constitution of the Swiss Confederation.

certain indicators are nevertheless considered although they reflect to a certain extent climatic, geographic, and economic factors. For example, performance in energy indicators reflect a country's average temperatures and the associated need to heat, the availability of fossil energy resources or geothermal energy and the relative price of energy. Coverage of such energy indicators makes nevertheless sense, because of a state's opportunity to influence type and quantity of energy consumption. By monitoring the development of such indicators (e.g. trend in renewable energy consumption (% of total energy) and not just status indicators, the influence of actions becomes visible.

All **states** can be rated based on this methodology<sup>2</sup>. The benchmark of different country groups might be used to correct for fundamental differences between states due to e.g. their development status (e.g. OECD vs. developing countries) or to compare different investment groups of countries (e.g. MSCI DM vs. MSCI EM). Indicators and scales are therefore chosen to allow a differentiation among all countries except for some indicators that are only available for the most important groups of countries (e.g. for OECD countries).

The rating provides clients with the **option to choose** the minimum level of sustainability for a positive result by choosing from a set of exclusion filters.

The rating is based on **publicly available, official and trustworthy sources** such as UN institutions (e.g. the International Labor Organization ILO, World Health Organization WHO), Bretton Woods Institutions (World Bank, International Monetary Fund IMF) or recognized NGOs (e.g. Freedom House, Amnesty International).

## 4 Methodological concept and structure

The conceptual framework of the Country Rating is based on an **exclusion module** and an **ESG module** with respective topics and criteria.

### 4.1 The exclusion module

The exclusion module covers topics related to the institutional framework of a state. They include indicators for core responsibilities and minimum requirements for states such as human rights, governance, democracy, governance and rule of law, peace keeping, etc. as well as the signatory status of major international conventions concerning labor, human rights and the environment. These are mainly long-lasting elements which are generally not affected by government changes or political processes.

Non-compliance with exclusion indicators leads to the status "excluded" in the Inrate Country Rating, otherwise the status is "no infringement". This means that infringements with requirements defined in the exclusion module cannot be compensated with an extraordinary performance of a country in other topics.

The exclusion status of countries is a highly relevant part of the methodology. The institutional framework and the necessary conditions measured with indicators of the exclusion module shape actions towards sustainable development in the long-term. Without adequate framework conditions and minimal democracy, human rights and governance standards, a good performance regarding social and environmental capital is hardly possible or not a consequence of a systematic path of a

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<sup>2</sup> However, for countries with not enough data, no grades are calculated.

state towards sustainable development. Inrate's Country Rating methodology implements that a long-term positive performance in the ESG module is only achievable if a solid basis in form of well-functioning institutional framework conditions exists (expressed as no infringement in the exclusion module).

Inrate has defined a set of exclusion indicators that we believe should be met fully or up to a certain point to fulfil the necessary conditions for sustainable development of a country. We call that set of exclusion indicators the "Inrate standard" and generally recommend our customers to refer to that set of indicators. However, we would like to offer utmost flexibility to our customers. Therefore, we offer them to individually compile their own set of indicators from the available exclusion indicators. This may mean to leave aside some Inrate standard exclusion indicators or attenuate them (e.g. a less strict exclusion if a customer wants to accept higher levels of corruption), or on the contrary include additional exclusion indicators (e.g. exclusion if single labor treaties or environmental treaties are not signed).

## 4.2 The ESG module

The ESG module covers a state's behavior and action towards sustainable development in respect of core dimensions of the sustainability concept: environmental capital (E) and social capital (S). Further, the governance dimension (G) covers topics related to the institutional framework of a state, which are in part also included in the exclusion module. The full set of indicators of the ESG module is available to clients only.

The ESG module is a snapshot of actions which are relevant for the sustainable development of a state. Poor performance regarding one topic can – to a certain extent – be compensated with a good performance regarding another topic. Changes from one year to another could occur as a result of changes in government composition, government priorities or political processes.

Assessments in the ESG module result in an ESG score, an ESG grade as well as separate E, S and G scores and grades for each state. The calculation is based on the following steps:

- The three dimensions of the ESG module environmental capital (E), social capital (S) and governance (G) encompass a set of 18 or more indicators each.
- Data of every indicator are normalized between an upper and a lower threshold to reach scores from 0 to 100 (with 100 being the best result). The threshold values are defined to limit the influence of extreme values and to include a normative judgement of limits that should not be exceeded or undercut to allow for a sustainable development.
- The E, S and G scores are then derived from the weighted sum of all normalized indicators of the dimension, with weightings being based on the relative importance of an indicator in terms of sustainability.
- For the ESG score, the separate E, S and G scores are weighted with 25%, 25% and 50%<sup>3</sup> respectively and summed up to the overall result on the scale 0 to 100.

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<sup>3</sup> Because an intact governance is regarded as an essential precondition for good social and environmental performance, it is weighted more strongly.

- The ESG score as well as the separate E, S and G scores are then transferred to grades on the scale A+ to D-. The scale translates as follows, with the threshold between sustainable countries and not sustainable countries being between B- and C+:

sustainable ↑ ↓ not sustainable	<b>A+</b> <b>A</b> <b>A-</b>	Very good to good performance in most of the E, S and G topics. High standard regarding the governance indicators as well as good performance regarding the environment and the social indicators of the ESG module.
	<b>B+</b> <b>B</b> <b>B-</b>	Over-average to average performance in many of the E, S and G topics. Average performance or minor deficits regarding some of the governance indicators as well as some of the environment or the social indicators of the ESG module.
	<b>C+</b> <b>C</b> <b>C-</b>	Under-average performance in many of the E, S and G topics. Minor deficits in many of the governance, environment or social indicators or major deficits regarding important indicators.
	<b>D+</b> <b>D</b> <b>D-</b>	Low performance in many of the E, S and G topics. Under-average performance regarding most governance, environment or social indicators or strong deficits in the most important indicators.

### 4.3 Sustainable Development Goals

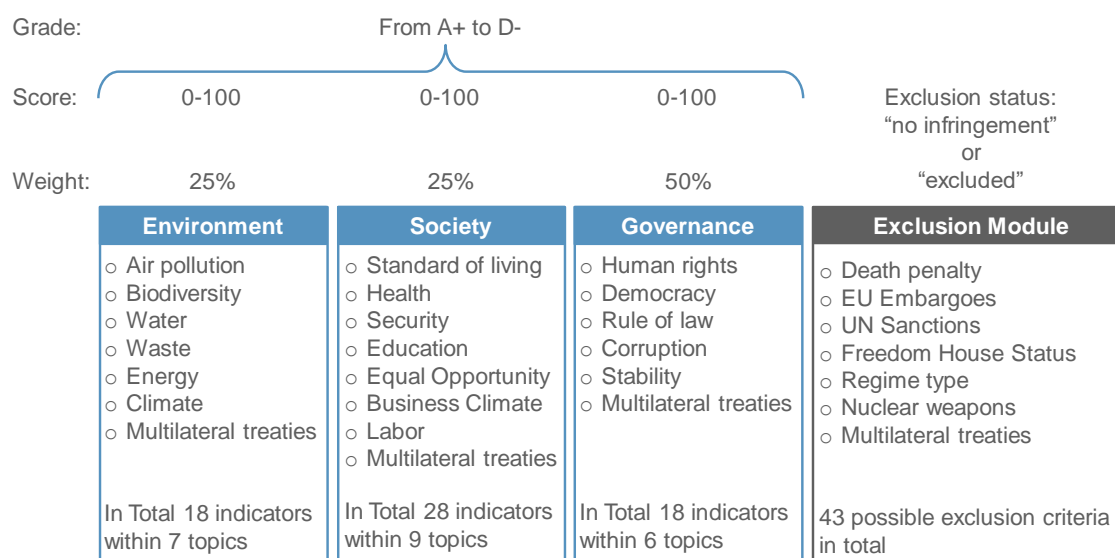
The 2030 Agenda and its Sustainable Development Goals (SDGs), endorsed by all 193 UN member states in September 2015, reflect global priorities to address the world’s most pressing environmental, social and economic challenges. The 17 SDGs strive for eradicating extreme poverty, achieving gender equality, ensuring access to water, making cities sustainable, or combating climate change and its impacts. As these goals are forming an integral part of a state’s policy choices, the topics of the Inrate ESG module are linked to the respective SDGs. If an Inrate ESG topic directly contributes to an SDG, the SDG will be portrayed in the topic column of the Inrate ESG module. The SDGs are only displayed for informative reasons and do not influence the results of the country rating.

### 4.4 Overall results

The overall results of the state rating consist of the **status of the exclusion module** (“no infringement” or “excluded”) and the **ESG grade** (A+ to D-) (figure 1). The overall results are to be understood in the sense that states promote sustainable development when they reach the exclusion status “no infringement” and achieve scores between A+ and B- in the ESG module. We recommend that customers consider these states as investable for sustainable investments.<sup>4</sup>

<sup>4</sup> Clients may deviate from that recommendation; however, it shouldn’t be necessary because the exclusion module can be customized according to customer’s needs.

Figure 1: Exclusion status and ESG grade combined form the overall state rating result



## 5 Coverage and data sources

The Inrate Country Rating collects and assesses data of 200 states and other sovereign bond issuers<sup>5</sup>, including Hongkong and Occupied Palestinian Territories, further Taiwan (Republic of China), and the British Overseas Territories Bermuda and Cayman Islands as well as the British crown dependencies Guernsey and Jersey<sup>6</sup>.

The methodology allows assessment and calculation of a final grade for roughly 140 states, further data availability allowed for calculation of either Environmental, Social or Governance grades (but not all of them) for another 59 states. For more information about handling of missing data see the following chapter.

### 5.1 Data sources, quality and availability

The Inrate Country Rating is based on secondary data from a range of primary sources (e.g. World Bank, World Health Organization, UNDP). Data quality depends on the source and the state being rated, but can in general be described as relatively good, as data of a single indicator stem from one and the same source and are therefore derived with one and the same method. However, the problem of poor data availability for certain countries exists. Differences in data availability is particularly noticeable between OECD and non-OECD countries.

### 5.2 Handling of missing data

Some states do not provide statistical data regarding the indicators which are relevant for the Inrate Country Rating. For example, they do not collect comprehensive data on the issue of employment, or

<sup>5</sup> For simplicity reasons also referred to as "states"

<sup>6</sup> For some countries or territories data availability is poor.



they do not calculate internationally standardized indicators such as the unemployment rate, which could be compared with other states.

Our methodology sets a specific weight for each indicator within the social, the environmental and governance dimensions of the ESG module. In case of a missing value, the respective indicator will not be considered in the calculation, by setting the weight to zero. With this process we can avoid scores that underestimate a state's efforts towards more sustainability. No calculation is done for states, for which more than half of the data (weight corrected) are missing in the social, the environmental or the governance dimension.

## **6 Update process and quality review**

### **6.1 Update process**

Inrate's Country Rating is updated at least on an annual basis, currently to times per year. Dedicated analysts research the available data. In doing so, the analysts

- integrate most recent data from primary sources into the calculation sheet and verify substantial changes in the raw data;
- check the ratification status for major international treaties;
- recalculate the results and assessments for the sovereign bond issuers within the Inrate Country Rating.

### **6.2 Quality review**

Quality review steps are in place to ensure that the research conducted is incorporated correctly and accurately. In conducting the quality review, the product manager

- peer reviews the data collection process;
- ensures that all relevant sources have been mined for data;
- reviews, evaluates and scrutinizes all changes in assessments.

Before new results and methodological descriptions are delivered to clients, Inrate's Product and Method Committee (PMC) must sign off the results.

## **7 Methodological update and continuous evaluation of data sources**

In the past decade, due to a multitude of global efforts including, for example, the Sustainable Development Goals, there has been an increase in the amount of data available which could potentially be used in an environmental, social and governance assessment of states. Due to this trend, Inrate re-evaluates existing sources during the data update process and regularly evaluates new data points that could add value and increase the robustness of the sustainability impact assessments of sovereign bond issuers. New sources might provide better quality or newer data. Furthermore there may be additional aspects like for example new multilateral treaties that need to be incorporated into the assessment (for example, the Paris Agreement in 2016).

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