Environmental and social risk rating (ESRR) methodology

Providing clarity and transparency for the environmental and social impacts associated with an institution's financial relationships.

ESRR methodology

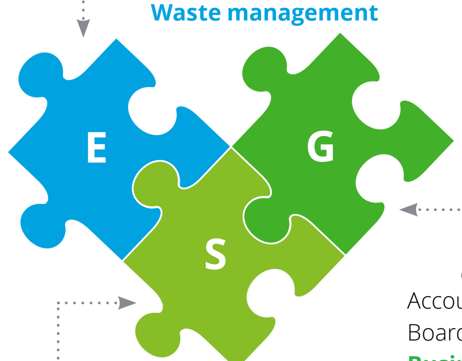
The ESRR is a methodology that assigns a composite score to commercial clients and enhances a financial institution's understanding of a client's ability to manage potential and actual environmental and social (E&S) risks. It can assist front-line staff in identifying clients or transactions that have higher potential for E&S risks, allowing to institution to elevate decision-making for potentially problematic financial relationships.

ESRR: Demystifying hard-to-quantify risks

Environmental and social (E&S) risks
Environmental and social risks are the potential negative consequences to a business that result from its impacts on the natural environment (e.g., nature, ecosystem) or on people and society.

Areas where use of ESRR can improve clarity and aid decision-making:

Environmental changes
Carbon emissions
Natural capital
Renewable energy
Water stress
Waste management



Accounting
Board composition
Business ethics
Corruption and bribery
Ownership
Shareholder rights

Customer welfare
Human capital
Human rights
Labor practices
Privacy and data security
Product quality and safety

The need for environmental and social risk ratings

Why focus on E&S risks?

- All business models depend on E&S inputs, such as natural resources, at some point on the value chain.
- For a financial institution, understanding E&S vulnerabilities as well as mitigating practices of potential clients or partners can lead to more clarity, better risk underwriting, and better governance decisions.
- To date, climate-related risks have gotten the most attention from companies and regulators. Other E&S issues, such as biodiversity and human rights, are starting to be recognized as equally important.
- Many institutions have climate programs underway but are lacking a holistic approach to environmental and social risk management (ESRM).

The foundation of a strong business in financial services…

…is decision-making based on informed, broad, and repeatable metrics. This foundation is well-formed in areas such as market or credit conditions. Bringing environmental and social risks into the fold can provide a competitive edge.

Boost reputation

Whether it's called sustainability; environmental, social, and governance (ESG) issues; or something else, a wide spectrum of stakeholders has growing expectations for how you handle risks in the environmental and social spheres. Qualitative paeans about your values are not enough—proving it through actions, models, and measurement is the new standard.

Upgrade risk management

An ESRR methodology can strengthen your risk management processes by quantifying an important component of ESG risk and reducing subjectivity. These improvements can contribute to better decision-making and enable the organization to align with the expectations of important stakeholder groups such as regulators, customers, and investors.

Capitalize on the opportunities of ESG

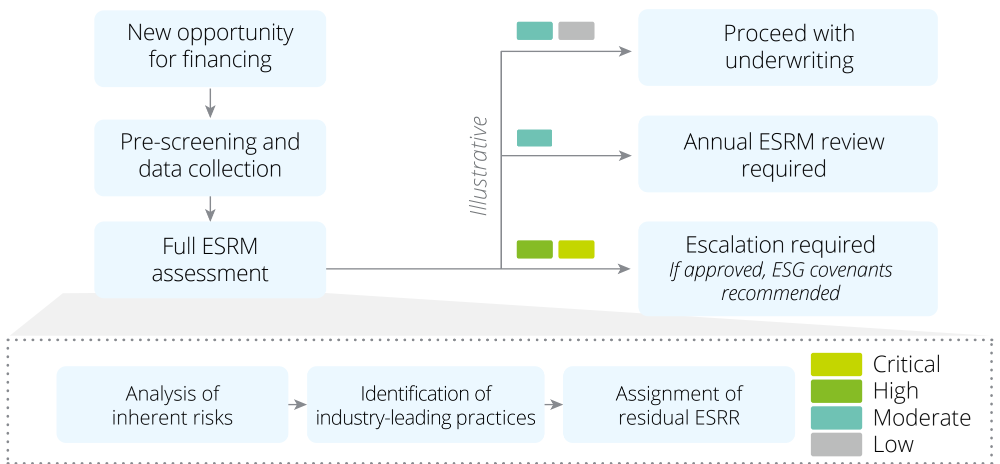
No one knows your business better than you. Internally controlled ratings—tailored to your needs, culture, values, and strategy—can serve you better than off-the-shelf offerings. Along with improving your understanding of risk, these ratings can give you greater insight into opportunities in the marketplace that might be underserved or overlooked by other financial institutions.

ESRR-methodology

The methodology helps identify and assess the presence of and relationship between inherent risks and risk mitigation controls associated with a commercial entity's industry, business model, geography, supply chain, and products or services.

Rating approach

Deloitte's ESRR method is tailored to each user's risk assessment preferences, including risk parameters, governance models, due diligence practices, and customer or third-party account life cycles while leveraging industry leading practices, such as the Equator Principles and IFC Performance Standards. By fitting the methodology to each user's unique needs, goals, and risk appetite, the ESRR provides a valuable, tailored experience to help companies manage environmental and social risk.



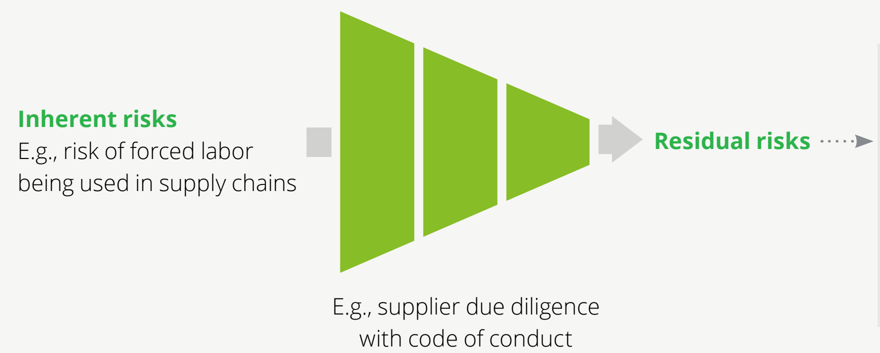
Scoring overview

The model assesses E&S risks within three main pillars: climate, nature, and human rights.

A client's residual ESRR is calculated by mapping the client's inherent risks to the appropriate risk mitigation controls to control for each risk.

For each inherent risk that is present, points are added to the client's overall score based on the level of risk.

For each leading practice the client has in place, points are deducted from the client's overall score based on the effectiveness of the control in relation to the level of risk.



Rating scale

Low | **Moderate** | **High** | **Critical**

The client's final overall score determines the client's residual ESRR based on a four-point rating scale: low, moderate, high, and critical.

Methodology

Flag and research

- **Prescreen questionnaire**: Collect information on a client's operational footprint, the types of products and services provided, and the risk mitigation controls currently in place.
- **Data collection**: Collect ESG relevant data from both internal and external data and tools.
- **SME due diligence**: Understand how clients they are managing their ESG risks and how to interpret their responses.

Assess and score

- **Inherent risks**: Identify, assess, and score the environmental and social risks that financial institutions are inherently exposed to through their businesses before any controls or mitigations are applied.
- **Risk mitigation controls:** Assess the financial institution's alignment to risk mitigation controls.
- **Client profile:** Understand the client's capacity to manage the risk associated with its lending and investment activity.

Manage and report

- **Residual risk score**: Calculate the residual risk by mapping the client's inherent risks to the appropriate risk mitigation controls for each risk with appropriate weighting to each category.
- **Action plans**: Disclose information relevant to the E&S action plan goals, performance, and outcomes.
- **Corporate watch list**: Develop a watchlist and ongoing monitoring requirements.

Environmental and social risk management strategies should reflect emerging and evolving environmental and social risks associated with the clients and communities served and be developed in collaboration with impacted stakeholders.

Contacts

Ricardo Martinez
Advisory Principal
Deloitte & Touche LLP
+1 212 436 2086
rimartinez@deloitte.com

Sarah Haley
Advisory Sr. Manager
Deloitte & Touche LLP
+1 980 376 4115
shaley@deloitte.com