SUSTAINALYTICS
a Morningstar company

Material Risk Engagement

2021 Q4
Quarterly Report

Material Risk Engagement promotes and protects long-term value by engaging with high-risk companies on financially-material ESG issues.

Contents

This report summarizes the shareholder engagement activities that Sustainalytics performed between 16 August to 15 November 2021.

Executive Summary

Palle Ellemann
Director and Product Manager for Material Risk Engagement

Sustainalytics' Material Risk Engagement program continues to expand and produce positive results from engagement activities. Over the past three months, we conducted 70 meetings and had 524 email exchanges and phone calls. More importantly, our efforts are generating results, including 26 positive developments and two successfully resolved engagements.

Realizing progress

Positive developments are defined as new initiatives that engaged companies have implemented that generate tangible results related to our suggested actions.

An engagement dialogue is considered resolved when a company's ESG Risk Rating score improves to below 28 (moving it into the Medium ESG Risk Rating category), reflecting lower unmanaged ESG risk. This quarterly report features details on two engagements that were resolved and includes examples of the Positive Developments achieved. (see Engagement Results, pg. 8)

Focus on Climate Change

This quarter, our team added a section on climate change – an integral part of many of our engagement dialogues with companies. In fact, carbon risk management and other climate-related risks are material in about three out of four engagements within MRE. Clients subscribed to the full MRE program are associated with approximately 250 engagements that include climate change.

Product Governance needs attention

Also included, you'll find an article by two of our Engagement Managers that explores why Product Governance is important and what it involves for specific industries. This issue is often a key focus area within our engagements, and we are already making progress in the automobiles industry.

Program enhancements

Now, you will benefit from the implementation of our previously announced program enhancements. We will now focus on mid- and large-cap companies and expand our engagement criteria to include companies with an ESG risk rating score of 30 or above. (The previous threshold was 32+) We have archived 46 engagements—mostly with small-cap companies. Eighteen engagements have been added, so there are now 330 active engagements in MRE in total.

These enhancements are designed to increase investor impact and overall engagement relevance. Clients can find an updated MRE Target group on the MRE landing page on Global Access.

For general program questions, please send an email mre@sustainalytics.com or your Sustainalytics regional client representatives.

2021 Q4 Statistics

330
Active Engagements as of 15 Nov. 2021

421
companies engaged since March 2020

524
Emails and Phone Calls

70
Meetings

26
Positive Developments

COMPANY RESPONSE

Excellent	4%
Good	43%
Standard	29%
Poor	6%
None	18%

COMPANY PROGRESS

Excellent	0%
Good	20%
Standard	55%
Poor	2%
None	23%

2
Engagements Resolved

Material Risk Engagement 2021 Q4 Statistics

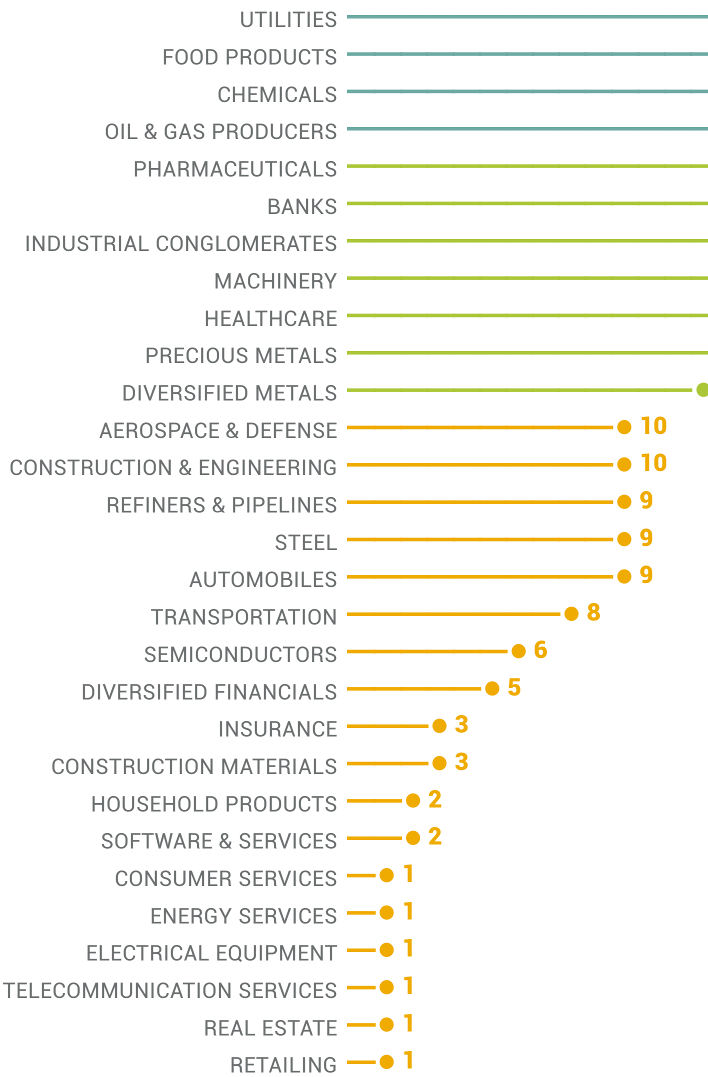
Status of Engagement by Research Universe

Ratings	ENTIRE UNIVERSE	GLOBAL DEVELOPED	GLOBAL EMERGING
Total Engagements	378	226	160
Resolved	2	0	2
Archived	46	27	19
Remaining Active Engagements	330	199	139

Active Engagements by ESG Risk Ratings Categories

Negligible (0-10)	Low (10-20)	Medium (20-30)	High (30-40)	Severe (40+)
		6% (28-30)	61%	33%

Industry Distribution



Regional Distribution

Engagement Topics

Engagement with companies within the MRE program focuses on Material ESG Issues with the largest management gaps as measured by Sustainalytics' ESG Risk Ratings. Engagement typically covers multiple Material ESG Issues as most companies have several ESG management gaps. The table below outlines the main topic(s) of each engagement (most engagements involve more than one issue).

About one-third of the engagements are focused on ESG risk assessment and disclosure practices. A sound and efficient ESG risk assessment process is fundamental for effective ESG risk management. A good risk assessment process should inspire constructive dialogue with internal and external stakeholders and help companies establish accountability and focus on material issues. Once a company is clear on its risks, it can move on to risk mitigation. As seen in practice, robust ESG disclosure is an important driver for commitment to and consistency in ESG practices. What gets measured gets done.

Beyond ESG disclosure, carbon-related issues are the most common focus. This is even more evident when we also consider the additional issues within our engagements. Carbon/climate-related issues are often highlighted among the suggested actions for companies to address. Product governance is another principal engagement focus, as it often relates to significant liabilities for companies and investors.

TOPICS	NUMBER OF ENGAGEMENTS
Risk Assessment and ESG Disclosure	99
Carbon Risk Management	50
Product Governance	26
Emissions, Effluents, and Waste	19
Corporate Governance	14
ESG Integration in Financials	9
Occupational Health and Safety	8
E&S Impact of Products and Services	7
Business Ethics	7
Human capital	3
Land Use and Biodiversity	2
Resource use	2
Community relations	1
Data Privacy and Security	1

Focus on Climate Change

MRE does not engage on specific thematic focuses but instead focuses on material ESG issues for each company. However, climate change is a relevant risk factor for most companies in one way or another. In fact, we see that carbon risk management or other climate-related risks are material in about three out of four engagements in MRE. Clients subscribed to the full MRE program are associated with approximately 250 engagements that include climate change.

Some of the most carbon-intensive industries like utilities, oil & gas, steel, and extractives are well represented in MRE as we consistently engage with companies with the largest management gaps. In the MRE target group, 72 of the companies are part of the Climate Action 100+.

MRE is promoting climate action in a structured way with a focus on real-world change. We often engage in getting companies to:

- Commit to TCFD reporting
- Track scope 1-3 carbon emissions
- Set (science-based) targets for carbon reductions in short-, medium- and long-term
- Dedicate proper resources to achieve targets
- Implement specific initiatives to achieve real carbon emission reductions as opposed to carbon offsetting and future potential for carbon capture

MRE is well-positioned to address the complexities of climate change risk mitigation as it differs from industry to industry and company to company. Our engagement is designed to create maximum impact for each company—we always look at companies individually and provide recommendations.

Carbon Related Risks

- Carbon Own Operations
- Carbon Products & Services

Other Climate Related Risks

- Emissions Effluents & Waste
- E&S Impacts of Products and Services
- ESG Integration - Financials
- Land Use & Biodiversity (+ Supply Chain)

Three out of four *engagements in MRE involves focus on carbon risk management or other climate related risks.*

Engagement Results

Throughout the current period, we conducted 70 meetings and exchanged 524 emails and phone calls with companies in our MRE program. We track our target companies' performance in various ways throughout the engagement process.

First, we assess each company on its awareness of ESG and willingness to engage with Sustainalytics and investors. 47% of engaged companies achieved a good or excellent response, a six-point increase from the previous period. For companies that did not respond to our initial outreach, Engagement Managers explore alternative strategies to establish a dialogue. Effective practices include reaching out to senior management or board members, joining investor calls and engaging investor clients with a specific interest in the non-responding companies.

Second, we assess the extent to which engaged companies adopt our suggested actions. As there are still a high number of new engagements, verification of actions is still in progress. These companies received a neutral rating of "standard progress," accounting for 55 percent of total cases. This is, however, significantly lower than the 68% in the previous quarter because we are having more follow-up meetings to validate progress. Additionally, we track when suggested actions are implemented as "positive developments".

Finally, company performance is evaluated as part of its ESG Risk Ratings assessment, which we update annually. An engagement is considered resolved once the company improves its performance to bring its ESG Risk Rating score below 28.

In the previous quarter of the year, Sustainalytics recorded ***26 positive developments*** *in engagements where the companies implemented the suggested actions. Two engagements where* ***resolved****.*

Examples of Positive Developments

COMPANY	INDUSTRY	POSITIVE DEVELOPMENT
Jardine Matheson Holdings	Industrial Conglomerates	Established a group-wide whistleblower service to complement existing whistleblower practices.
SUMCO Corp	Semiconductors	Established ESG governance structure to monitor overall ESG issues by setting up an ESG/SDGs committee.
TransDigm Group Inc	Aerospace & Defense	Completed inventories of carbon emissions, energy use and water use for 2019 and 2020.
Hyundai Motor Co., Ltd.	Automobiles	Introduced statistical disclosures on product recalls and associated costs.
PGE Polska Grupa Energetyczna SA	Utilities	Established a plan for carbon neutrality and made significant investments in renewable energy.
Aker BP ASA	Oil & Gas Producers	Aker BP ASA's corporate governance report, which provides insight to the KPIs in the performance system, now includes safety and CO2 intensity.
Mahindra & Mahindra Ltd.	Automobiles	Introduced science-based intermediate milestones and targets to achieve the carbon neutrality.

Company: Korean Air Lines Co
ESG Risk Ratings Score

Negligible (0-10)	Low (10-20)	Medium (20-30)	High (30-40)	Severe (40+)

26.4

INDUSTRY
Airlines

BASE LOCATION
South Korea

ENGAGEMENT FOCUS
Corporate governance
Business ethics
Carbon own operations
Human capital

RATIONALE FOR RESOLVED STATUS
Korean Air Lines improved their ESG Risk Rating score to below 28.

Positive Development Highlights:

- Korean Air made several corporate governance improvements. The company appointed a new non-executive Chairman, thereby separating the CEO and Chairman of the board roles. It established a new Governance Committee, entirely comprised of independent board members. This committee supervises ESG risks and impacts. Finally, the first female board member has been appointed.
- As a member of the International Air Transport Association, Korean Air committed to the CNG2020 (Carbon Neutral Growth 2020) initiative and a long-term target to reduce GHG emissions by 50% before 2050.
- Korean Air is further developing its commitments and plans for transitioning to low carbon aviation. It has committed to local energy efficiency targets that are more ambitious than general sector targets (2% versus 1.5%). It is so far outperforming these targets, which also means avoiding any cost in the Korean carbon exchange trading system.

In our latest ESG Risk Rating assessment, Korean Air improved its ESG risk management score by more than 14 points, bringing it into the medium risk category and below our 28-point threshold for engagement.

Company: Kia Corp
ESG Risk Ratings Score

Negligible (0-10)	Low (10-20)	**Medium (20-30)**	**High (30-40)**	**Severe (40+)**

26.7

INDUSTRY
Automobiles

BASE LOCATION
South Korea

ENGAGEMENT FOCUS
Product governance
Carbon product and services
Corporate governance
Human capital

RATIONALE FOR RESOLVED STATUS
Kia Corp improved the ESG Risk Rating score to below 28.

Positive Development Highlights:

- Established a new ESG team to drive ESG risk management and improve ESG disclosure.
- Disclosing statistics on the use and outcome of its grievance mechanism.
- Significantly improved product governance disclosure, including coverage for QMS and scope of recalls and the costs associated with recalls.
- Developed more details around intermediate carbon reduction targets for 2030 and 2040 before the final carbon neutrality goal in 2045. The roadmap includes initiatives and capex to achieve the targets.

In our latest ESG Risk Rating update, Kia Corp's risk management score improved by more than 20 points, bringing the company into the medium risk category and below the 28-point threshold for engagement.

Thought Leadership: Product Governance Needs More Attention

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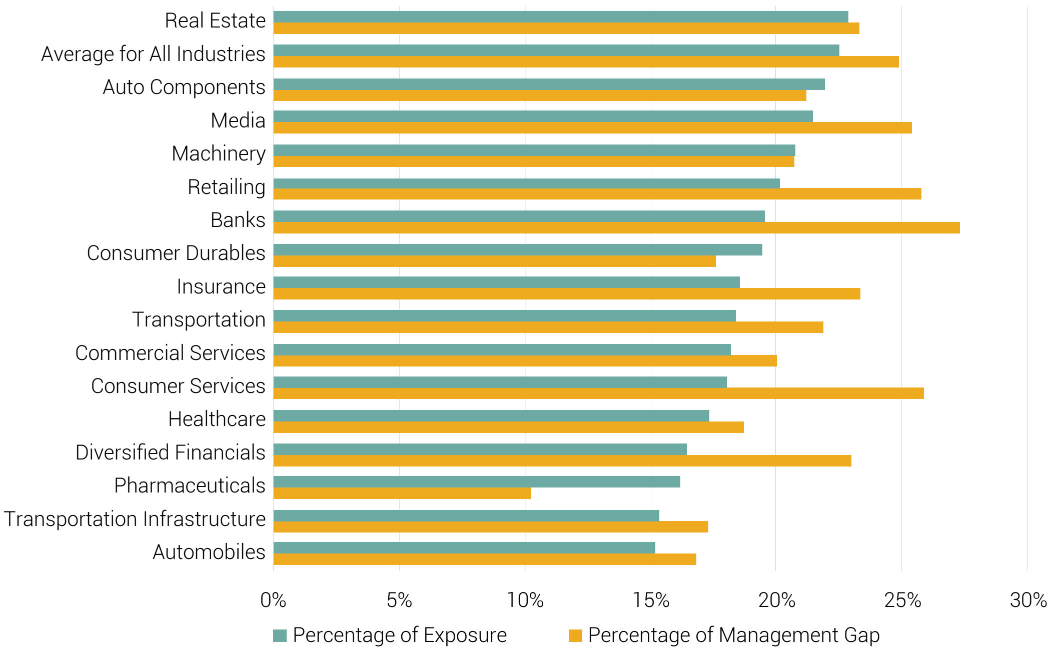
Sustainalytics' Material Risk Engagement programme engages with more than 320 companies in about 30 different industries worldwide. In 68% of our engagements, product governance is a significant material ESG issue, but it is our experience that most companies underestimate the materiality of this risk to investors. For some industries, product governance represents on average more than 20% of ESG risk exposure, as identified within our ESG Risk Rating framework. Moreover, as shown in figure 1, this issue represents even a larger portion of the management gap for almost all industries, reflecting relatively weak management of product governance risks. Product Governance remains one of the most ignored ESG issues across industries despite the significant level of risk it presents to companies.

Figure 1: Materiality of Product Governance



Source: Sustainalytics ESG Risk Rating

Product governance focuses on managing the risks to a company's customers in using its products or receiving the services. Another product-related issue, like E&S Impact of Products and Services, is about the social and environmental impacts of a company's products and services. Product quality and safety are certainly important parts of product governance, but it is much more than that for many industries. For example: For financials, product governance focuses on responsible marketing and ensuring customer suitability to avoid misconducts including discriminatory lending practices, predatory lending, misleading investors through poor disclosure and illegal foreclosure practices.

- For automobiles, it includes the integrity and accuracy of companies' product claims (including the marketing of safety performance and fuel economy levels) and the sales practices of companies' financing services.
- For pharmaceuticals, it includes informing customers or responding to complaints about unanticipated side effects.

Considering the materiality of these issues, it is surprising that more companies do not bring product governance to the forefront of ESG disclosure. Poor management of product-related risks can have an immediate impact on sales and reputation and lead to massive fines.

Below we dive deeper into automobiles and financials to share some insight from our engagements experience with companies in these sectors.

Automakers Showing Progress

The "Dieselgate" scandal with Volkswagen that emerged in 2015 continues litigation and has a negative impact on the brand. In 2020, Volkswagen admitted that the scandal had cost 31.3 billion euros in fines and settlements. The scandal led to the automotive industry reviewing its practices for calculating fuel efficiency, resulting in more realistic and comparable measures for consumers.

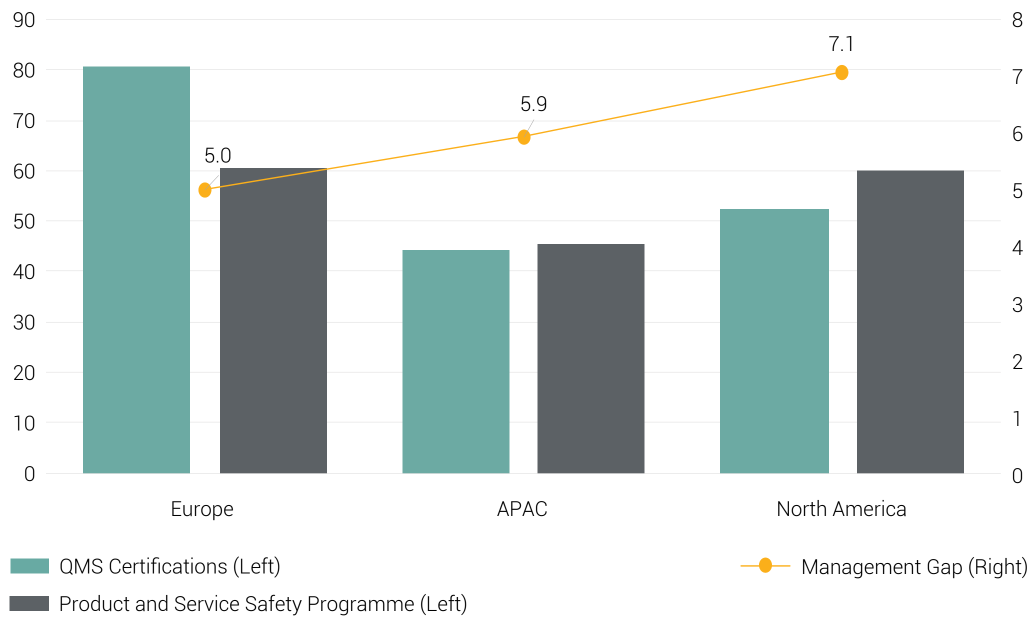
We are engaging with 11 of the largest automakers in the world and are looking at product governance beyond fuel efficiency. The industry is under fierce competitive pressure combined with heightened expectations from regulators and consumers to decarbonize products and production. This is creating a focus on innovation, and companies are releasing new models at a fast pace. Combined with the growing technological complexity of the vehicles, this increases the risk for incidents related to product quality and safety.

Investors need to have a line of sight into companies' performance in managing product quality and mitigating safety hazards. Still, until now, it has been the exception rather than the rule for automakers to disclose statistics on product incidents and recalls. Major incidents or recalls have often been disclosed in separate announcements, making it difficult to get insights into a company's overall performance in an entire year.

Sustainalytics has engaged on these issues, and we have seen much better disclosure on product incidents and recalls from Hyundai and Kia. Both companies also recognize that product quality needs to improve to reduce product incidents and recalls, which have a directly associated cost and damage the customer experience and, therefore, the brand.

Our research shows that North American automobile companies have a higher management gap on product governance than Europe and APAC (figure 2). Notice here that product-related incidents picked up in our research increase management gaps, so even if North America has better product and service safety programmes than the APAC region, the management gap is on average higher. There is significant potential to engage on more consistent quality management practices and more cohesive product safety programmes.

Figure 2: Automobile Sector Performance Comparison



Source: Sustainalytics ESG Risk Rating

Financials – Beyond Customer Experience

For financial companies, including banks, insurance and diversified financials, product governance goes beyond customer experience and satisfaction. Misconduct in marketing and customer suitability, such as discriminatory lending practices, predatory lending, misleading investors through poor disclosure and illegal foreclosure practices, has resulted in significant operational and reputational damages, as well as expensive fines.

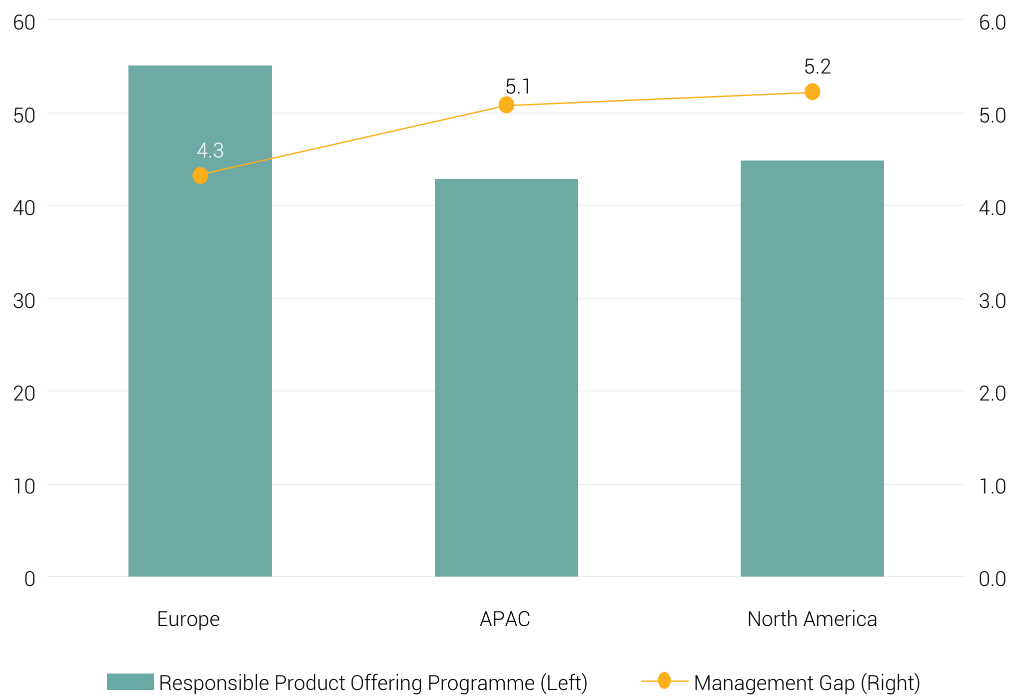
For example, some of the world's largest banks have been involved in customer-related investigations and lawsuits related to misrepresenting the risks of mortgage-backed securities, misleading IPO statements and charging inappropriate fees. The settlements of these investigations and lawsuits have cost banks billions. Credit Suisse has so far made legal settlements amounting to over USD $5 bn and faces further lawsuits, which could increase the legal and financial risks associated with a Mozambique bond offering controversy.

Best practices to manage these risks include:

- Having a clear governance structure to oversee responsible product offering matters,
- Conducting risk assessments of new products and services to verify that they fulfil the needs of consumers before they are launched,
- Continuous monitoring of social impact and risks of existing products and services, and
- Provide regular training of employees on responsible product offerings and marketing.

Our research (figure 3) finds that European financial companies historically tend to outperform North America and APAC on product governance, partly because they demonstrate stronger responsible product offering programmes. However, APAC financial companies have recently been involved in fewer product quality controversies than their European and North American counterparts. This could be due to heavier financial regulations in many APAC countries.

Figure 3: Financial sector Performance Comparison



Source: Sustainalytics ESG Risk Rating

From an engagement perspective, we work with financial companies to integrate ESG holistically into their operations, from risk assessment to product design and risk management. We encourage commercial banks to adopt the Principles for Responsible Banking initiative as a relevant reference point and network to adopt best practices. We encourage alignment and participation in the Principles for Responsible Investment for financial companies involved with asset management. Combined with ESG integration, financial companies need a robust code of conduct that addresses ethical issues related to products and customer management.

Plans for Q1 2022

Next quarter, we will hold follow-up meetings with many of the engagements we started in 2021. We anticipate a related increase in positive developments. We will continue scaling up the number of engagements, particularly with large-cap companies that have been included due to the changes in our selection criteria for MRE. Clients are encouraged to follow new cases in the EMEA region, where we will be opening engagement with many well-known companies.

Covid-19 continues to make it challenging to travel for in-person meetings, but we will closely monitor travel restrictions. We look forward to the possibility of scheduling in-person meetings in 2022.

Material Risk Engagement Approach

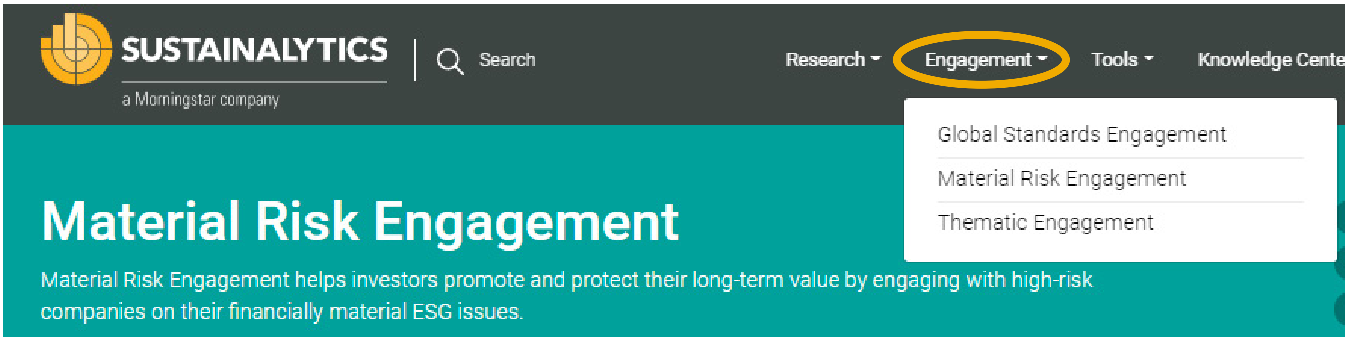
Sustainalytics' Material Risk Engagement (MRE) engages with high-risk companies on the material ESG issues with the greatest levels of unmanaged risks. The purpose is to protect and develop long-value in our clients' portfolio companies. MRE is an engagement overlay of Sustainalytics' flagship product, ESG Risk Ratings.

The Stewardship team will engage with companies in Sustainalytics' Ratings universe, consisting of more than 4,500 companies, that have an ESG Risk Ratings Score of 30 or more. The ESG Risk Ratings score reflects the unmanaged ESG risk, so the higher the score, the more risk the company is exposed to.

The engagement is driven by constructive dialogue. The research from ESG Risks and the Controversies research are leveraged to encourage companies to cover gaps in Material ESG Issues risk management. Engagement response, progress and positive developments are consistently tracked to measure commitment and capability to change in addition to the engagement outcome. When a company improves by bringing the ESG Risk Ratings score below 28, the MRE will be considered resolved.

How to Generate Reports from Global Access

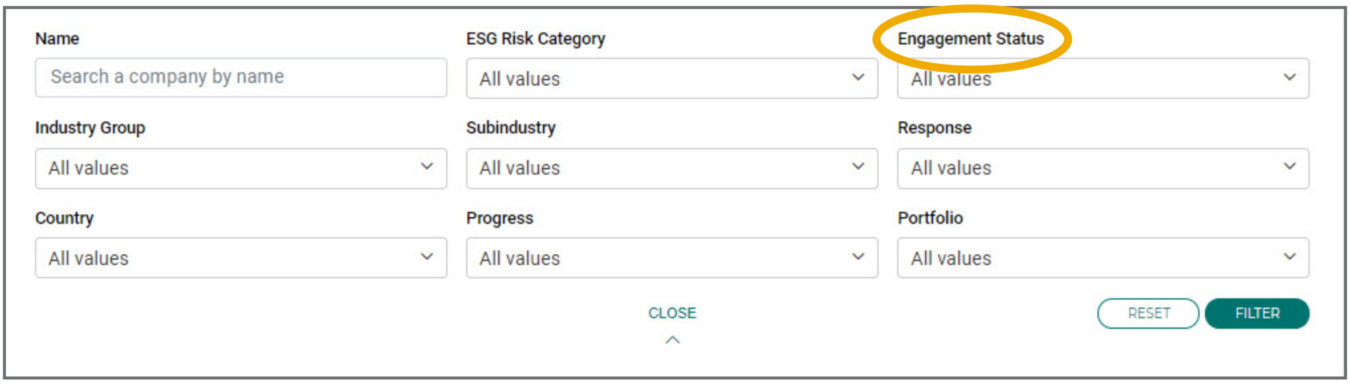
MRE clients can generate individual reports from Global Access, allowing visibility to the status of engagement activities and progress. From the landing page of **Global Access**, find **Material Risk Engagement** under the **Engagement** tab.



On the **Material Risk Engagement** landing page, scroll down to the search section, to search for a specific company or filter by various criteria including industry group, country, response, and progress.

Reports can be generated for an individual portfolio if a portfolio has been uploaded to the user's account in the **Portfolios** section under the **Tools** tab. Once a portfolio is uploaded, it is available under the **Portfolio** filter in the search section, in addition to other standard research universes.

To see the number of engagements in a portfolio, select **Engage** under the **Engagement Status** and the portfolio under **Portfolio**. This will produce a report that includes multiple data points for the companies selected.



Do you have any questions regarding our Stewardship Services?

Contact us today to connect with our team of experts.

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