

# ESG ratings criteria and methodology

May 2024

## Background

Environmental, social and governance (ESG) principles have grabbed the attention of investors, issuers, academicians and policymakers the world over. Numerous empirical studies prove that managing ESG risks ensures sustainable long-term growth and better returns for businesses. ESG-conscious entities are able to diversify funding sources and raise capital on better terms, as well as earn market trust and stakeholder loyalty.

A similar story is being scripted in India, with global and domestic investors increasingly preferring ESG-focused assets. Regulators have also taken steps for the orderly development of the ESG ecosystem. The Business Responsibility and Sustainability Report (BRSR) introduced by the Securities and Exchange Board of India (SEBI) for the top 1,000 listed entities (based on market capitalisation) has standardised ESG disclosures.

In this backdrop, ESG rating<sup>1</sup> by CRISIL ESG Ratings & Analytics Ltd (CRISIL ESG Ratings) assists investors and lenders by offering an independent input on ESG aspects, helping them make an informed decision. The rating offers an independent opinion on a company's ability to manage ESG-related risks and opportunities in relation to peers. The rating also factors in the relative ESG risk the company is inherently exposed to on account of the sector it operates in.

## Scope

CRISIL ESG Ratings uses its proprietary methodology for assessing more than 500 key performance indicators (KPIs) across ~65 sectors. This document explains the CRISIL ESG Ratings' criteria used to arrive at ESG ratings.

CRISIL ESG Ratings provides an opinion on an issuer's ESG profile by assessing its exposure to ESG risks, internal governance factors, impact on society and environment, and ability to manage ESG risks and opportunities over the medium term. It involves cross-sector, relative benchmarking of issuers in India and is assigned on a scale of 0-100. The CRISIL ESG Ratings framework considers India-specific nuances such as standards, laws, regulations and guidelines related to ESG, while also factoring in global best practices.

The evaluation is based on publicly available information (assured and non-assured) released by entities through their websites, exchange filings, annual reports, investor presentations, press releases and sustainability reports. It also factors in other material ESG information available in the public domain through reliable sources, such as data reported by industry associations, regulators and government agencies. The assessment factors in both quantitative as well as qualitative disclosures to ensure a holistic assessment.

Each company under the CRISIL ESG Ratings coverage is subject to continuous surveillance for ESG related material events that could potentially lead to a material change in its ESG rating.

Considering the significant level of subjective judgment involved in ESG analysis, every company undergoes a meticulous committee process to support the assessment by CRISIL ESG Ratings.

Our ESG ratings can be used by investors and issuers to measure and monitor inherent ESG risks across their exposures – both, equity and debt. The ratings also provide standardised and sanitised ESG information that can be easily integrated by investors into their analysis and risk management processes.

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<sup>1</sup> Ratings and scores are used interchangeably in this document.

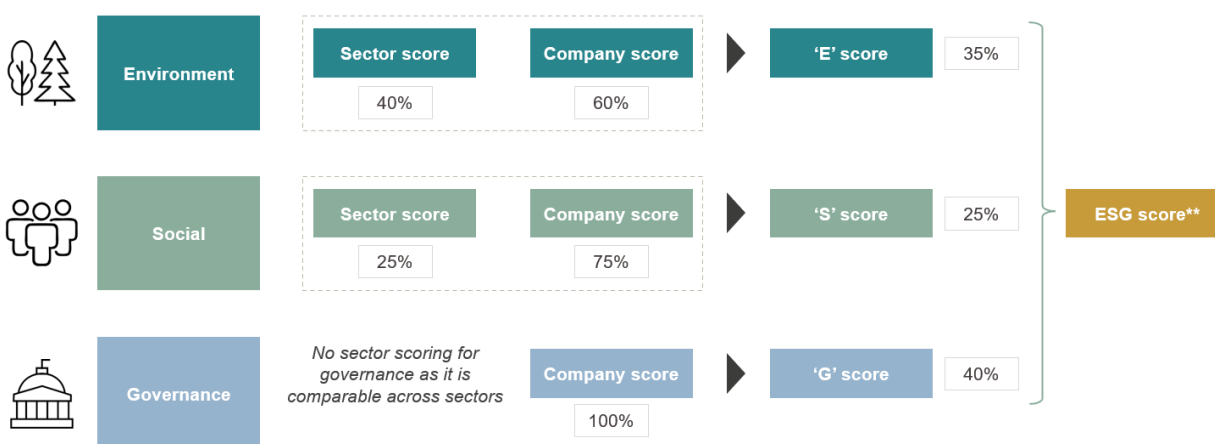
## Rating framework

CRISIL ESG Ratings assigns ESG ratings on a scale of 0-100, where 100 is the highest and 0 the lowest. This is in line with the standardised scale prescribed by SEBI for ESG rating providers (ERPs) in India.

The ratings are categorised into five buckets:

Weak	Below average	Adequate	Strong	Leader
0-40	41-50	51-60	61-70	71-100

## ESG rating assessment framework



\*\* On a scale of 0-100, with 100 being the highest and 0 being the lowest

To arrive at a company's overall ESG rating, it is scored on the individual Environment (E), Social (S) and Governance (G) factors on the 0-100 scale. These E, S and G scores are then combined using weights for E (35%), S (25%) and G (40%) to reflect their relative importance in the overall ESG rating. Governance has been assigned the highest weightage as robust governance practices are essential to drive the environment and social agenda of any company.

Furthermore, to evaluate the E and S parameters, CRISIL ESG Ratings looks at the company-specific performance in comparison with peers, as well as the sectoral performance. Thus, the final E and S scores are a combination of the company and sector scores, where the sector performance has 40% weightage in the company's E score and 25% in its S score. Governance is sector-agnostic and hence has no sectoral performance attached to it. For instance, the company's E score assesses its material environment parameters in relation to its peers within the sector. This approach allows CRISIL ESG Ratings the flexibility to bring nuanced sector-specific parameters into the assessment of a specific company while retaining the cross-sector comparability of the final scores.

### Sector scores

Sector scores are an indicator of how a sector fares relative to other sectors on various environmental and social issues. The sector scores are calculated and arrived at by ranking and benchmarking the sector averages of material KPIs with other sectors. Finalising scores for each sector involves a committee process where the analysis supporting the sector score is presented and opinions of panel members are taken into consideration.

The company's E score is the weighted average score of its environment score basis its KPIs (60% weight) and the respective sector score to which it belongs (40% weight). Similarly, the company's Social 'S' score is the weighted average score of its social score based on its KPIs (75% weight) and the respective sector score to which it belongs (25% weight).

Environment-related KPIs such as emissions, energy, water and waste intensities are largely dependent on the sector a given company is part of, whereas social-related KPIs such as gender diversity and consumer complaints are more dependent on the company itself. Thus, the weightage for E sector score is higher than S sector score.

### Sub-pillar weightages

The three pillars of E, S and G are further broken down into various sub-pillars, covering the key themes within each pillar (as seen below). The company score is arrived at by taking a weighted average of its sub-pillar level scores.

Pillars	Environment	Social	Governance
			
<b>Sub-pillars</b>	<ul style="list-style-type: none"> <li>Greenhouse gas (GHG) and air emissions</li> <li>Energy use</li> <li>Waste management</li> <li>Water management</li> <li>Resource use, green products and biodiversity</li> </ul>	<ul style="list-style-type: none"> <li>Employee and worker management</li> <li>Stakeholder management and product quality</li> <li>Communities</li> </ul>	<ul style="list-style-type: none"> <li>Board composition, independence and functioning</li> <li>Management track record and control</li> <li>Disclosures and financial statements</li> <li>Shareholder rights</li> </ul>
<b>Weightage</b>	35%	25%	40%

The CRISIL ESG Ratings proprietary framework considers sector-specific materiality and relies on extensive analysis to arrive at the sub-pillar weightages. Thus, the weights assigned to sub-pillars vary across sectors.

A range of sub-pillar weightages under the environmental and social categories for a broad sectoral grouping (services, manufacturing and infrastructure) is shared below.

Sector groupings	Environmental (35%)					Social (25%)		
	GHG emissions	Energy use	Waste management	Water management	Resource use and impact on biodiversity	Employee and worker management	Stakeholder management and product quality	Impact on communities
Services	3%-12%	3%-13%	3%-15%	2%-7%	1%-23%	7.5%-15%	5%-12%	2%-10%
Manufacturing	5%-12%	3%-9%	3%-12%	3%-10%	3%-15%	8%-13.5%	5%-12%	4%-10%
Infrastructure	8%-10%	4%-6%	5%-7%	5%-7%	8%-10%	9%-11%	7%-10%	5%-8%

As indicated by the table above, the sub-pillar weightages differ among sectors as a result of the unique circumstances and challenges of each sector. For instance, within manufacturing, the tyre sector has lower weightage assigned to emissions, at around 5-10%, due to low direct GHG emissions during the manufacturing process. However, the power, cement and metals sectors have higher weights for GHG emission, at 10-15%.

Assessment of governance, on the other hand, is sector-agnostic, and is broadly divided into board-related pillars like board composition, independence and functioning, which cumulatively account for a significant proportion of governance-related assessment. Sub-pillars such as management track record, quality of disclosures and shareholding rights make up the rest.

The board-related parameters are significant because the board of directors plays a crucial role in shaping a company's policies, strategies and overall governance. The effectiveness of the board influences how a company addresses its ESG issues and, hence, is assigned a higher weightage.

## Transition assessment

Transition, or *parivartan*, literally means change. In the context of ESG, transition risks arise due to need to transition to a more sustainable and low-carbon economy. Globally and in India, governments and corporates have taken up targets and adopted strategies towards meeting the UN Sustainable Development Goals (SDGs). There are various initiatives to move towards more sustainable operations.

Hence, to benchmark ESG performance, it is imperative to evaluate Indian issuers not only on past and current performance, but also factor in their concrete plans to address ESG risks and opportunities.

The transition risk assessment considers the incremental changes that the company has made in recent years, as reflected in performance trends across key ESG parameters, and incorporates clear and measurable targets to address the risk and opportunities involved in transitioning to more sustainable operations.

CRISIL ESG Ratings centrally incorporates transition assessment in its ESG rating methodology, which is reflected in the ESG ratings assigned to entities.

## Assessment parameters across each pillar

Some of the key assessment parameters across sub-pillars in E, S and G are shared below.

### Environment



#### GHG emissions

- Intensity of Co2 emissions (Scope 1+2)
- Intensity of Scope 3 emissions and categories disclosed
- Trend in emissions
- Climate change policy, physical & transition risk
- Intensity of air pollutants (Sox, Nox, SPM, ODS) emissions



#### Waste management

- Hazardous waste management
- Non-hazardous waste management
- Generation, disposal methods
- Recycling, reusing and other recovery methods



#### Resource use, green products and biodiversity

- Environmental consideration in the supply chain
- Efficacy of raw material use
- Sustainable/green products/services in portfolio
- Presence of IUCN protected species near place of operations
- Land/plants with Biodiversity Management Plan
- Environment impact assessment



#### Energy use

- Share of renewables in energy use
- Capital investment on energy conservation equipment
- Energy consumption
- Trend in reduction in energy consumption



#### Water management

- Water reused or conserved
- Water withdrawal by type (fresh, ground, saline, etc.)
- Water withdrawn from stressed areas
- Water discharge
- STP/ETP treatment, ZLD

Compliance/controversy checks are tracked and act as deflators to the rating. These include show cause notices due to violation of law with respect to levels of emissions, discharge, waste disposal.

**Social**



**Employee and worker management**

- Share of permanent workforce
- Gender diversity
- Talent retention/policies (attrition rate)
- Diversity, inclusion, well-being and human rights
- Lost time injury frequency rate (LTIFR)
- Training to employees on skill and safety
- Working condition + health and safety complaints
- Sexual harassment - redressal rate
- Wage equality
- Extent of unionisation



**Communities**

- Taxes paid (direct + indirect)
- Regulatory CSR spend
- Employment generated (current year)
- Mechanism for grievance redressal of local community
- Social Impact Assessments (SIA) of projects undertaken by the entity



**Stakeholder management and product quality**

- Vendor management
- Social consideration in supply chain
- Stakeholder complaints rate and redressal
- Net promoter score/CSI/feedback
- Data security
- % R&D spend per sector-specific metric
- Product safety and quality
- Ease of access: Network reach (no of branches/outlets, etc); technology reach

Compliance/controversy checks are tracked and act as deflators to the rating. These include child labour, discrimination, strikes, product recalls, irresponsible marketing, non-compliance – banned substances, minimum wages, sale of sin goods.

**Governance**

**Board composition and functioning**

- Integrity check: Members being investigated by any body, or associated with entities with adverse news on corporate governance
- Total number of board members: Composition
- Number of women board members: Gender diversity
- Share of independent directors on the board
- Composition of Committees (Audit, Risk, Nomination & Remuneration, etc)

- Committee meetings and attendance record
- Frequency and number of board meetings
- Formal interaction between independent directors without other directors or senior management



## Management track record, transparency and shareholder rights



Compliance/controversy checks are tracked and act as deflators to the rating. These include promoter/management issues, audit observations, statutory non-compliance and fines by regulators on the company and directors.

## Factoring in sector-specific nuances and materiality

The CRISIL ESG Ratings risk assessment framework for each sector has been developed by taking into account the relevant parameters specified in the BRSR and global reporting frameworks, such as Sustainability Accounting Standards Board (SASB) and Global Reporting Initiative (GRI). For a parameter to be considered material for a sector, CRISIL ESG Ratings applies filters from both, a risk perspective (how it may negatively impact a company’s financial risk and return profiles) and impact perspective (how the issue may impact the country’s ESG landscape).

The diagram below is an indicative list of sector-specific material parameters for some of the sectors.



### Cement

- Thermal substitution rate
- Clinker ratio
- Waste heat recovery system
- PAT regulations (Perform, Achieve & Trade)



### Airlines

- Share of sustainable aviation fuel in overall fuel mix
- Initiatives to use materials to make airplanes lighter
- On-time performance
- % of passengers affected due to denial of boarding and cancellation
- Safety rating by independent authority
- Aviation accidents/ incidents reports



### Banks/ NBFCs

- Financed emissions and negative sector exposure
- Funding to green projects
- Rural and semi-urban reach
- Priority sector lending



### Pharmaceuticals

- Product recalls
- Adverse regulatory actions (number of warning letters and import alerts)
- Number of Abbreviated New Drug Application (ANDAs) filed
- Access to affordable healthcare

## Handling non-availability or non-disclosure of quantitative information

Non-disclosure of quantitative information by a company for a specific parameter is assigned a default non-disclosure score, which is the lowest score possible for any parameter. In case there is some qualitative disclosure or material information available, CRISIL ESG Ratings will factor in the same while assigning a score for that parameter depending on the specificity, depth and action-oriented nature of the information.

## Deflators for compliance lapse, regulatory actions, controversies, or similar events

A deflator is assigned, using an extensive controversy framework, to the overall E, S or G company score if the company has been involved in controversies, or if there have been compliance-related lapses or regulatory actions against it, or any other material ESG-related incident.

For example, deflators on environment would include the company being fined by the Pollution Control Board, National Green Tribunal, and Coastal Regulation Zone Management Authorities for non-compliance. On the social front, safety incidents, child labour issues, worker strikes, community protests, would be considered. Governance deflators would include insider trading instances, regulatory fines or investigations, and regulatory actions on the promoters or directors.

## Industry classification

In-line with the SEBI ERP regulations, CRISIL ESG Ratings follows the standardised industry classification published by stock exchanges from time to time.



## Handling some unique corporate structures

### **Diversified companies:**

Companies engaged in multiple business segments, where no single business segment contributes more than 50% to the total revenue and two or more segments contribute at least 20% to total revenue, are generally classified as diversified.

The CRISIL ESG evaluation of such companies is based on a 'sum-of-the-parts' approach, considering the underlying companies/businesses they have exposure to, where weights are generally assigned in proportion to their asset base.

### **Holding companies:**

Our holding company classification is guided by the Reserve Bank of India's guidelines on core investment companies (CIC).

## Constraints of our framework

- **Disclosure bias:** The ESG scores are based only on publicly available information. Therefore, they are subject to disclosure bias — companies that have better disclosures will potentially get higher scores as opposed to those with no or poor disclosures, irrespective of their actual impact on E, S and G parameters. CRISIL ESG Ratings does not work with any ESG information shared by companies on a bilateral basis.
- **Listed company bias:** Listed companies are mandated by regulations to disclose more information in the public domain. Within listed companies, CRISIL ESG Ratings recognises that large-cap companies tend to get higher scores as they have access to more resources to make better disclosures and take steps to counter ESG risks. CRISIL ESG Ratings expects BRSR to resolve some of the disclosure-related limitations with regard to smaller companies.
- **Coverage bias:** The CRISIL ESG Ratings benchmarks are a function of the number of companies covered in a particular sector and the quality and quantity of disclosures within the sector. Hence, a material change in the coverage or the disclosure of ESG information within a sector can lead to year-on-year deviation in scores. However, as the coverage increases significantly and companies improve their disclosures, this bias is expected to fade.

CRISIL ESG Ratings will continue to review and update the ESG Rating methodology in the light of any regulatory change and improving disclosure levels.

## Glossary

ESG	Environmental, social and governance
SEBI	Securities and Exchange Board of India
BRR	Business responsibility report
BRSR	Business Responsibility and Sustainability Report
KPI	Key performance indicator
SASB	Sustainability Accounting Standards Board
GRI	Global Reporting Initiative
CO2	Carbon dioxide
Nox	Nitrogen oxide
Sox	Sulfur oxide
ODS	Ozone depleting substance
ZLD	Zero liquid discharge
STP	Sewage treatment plant
ETP	Effluent treatment plant
IUCN	The International Union for Conservation of Nature
CSI	Customer satisfaction index
R&D	Research and development
CSR	Corporate social responsibility
SIA	Social impact assessment
EIA	Environment impact assessment
CAGR	Compound annual growth rate
MDA	Management discussion and analysis
Scope 1 emissions	Scope 1 emissions are from sources that are directly controlled/owned by the company. For example, emissions from the boiler of a manufacturing unit.
Scope 2 emissions	Scope 2 emissions are indirect, resulting from the purchase of energy, including electricity, steam and cooling.
Scope 3 emissions	Scope 3 accounts for indirect emissions that occur in the upstream and downstream value chain of the company. For example, emission from the use of petrol would be Scope 3 emission for oil refiners.
Hazardous waste	Hazardous waste includes waste that is dangerous to human health or the environment.
Non-hazardous waste	Non-hazardous waste is all waste, except hazardous waste.
Water withdrawal	Water withdrawal is the amount of water withdrawn from various sources for operational purposes.

### **About CRISIL ESG Ratings & Analytics Limited (a wholly owned subsidiary of CRISIL Ratings Limited)**

CRISIL ESG Ratings & Analytics Limited (CRISIL ESG Ratings) is a Securities and Exchange Board of India (SEBI)-registered 'Category 1' ESG rating provider. It is a wholly owned subsidiary of CRISIL Ratings Limited ('CRISIL Ratings', a SEBI-registered credit rating agency. CRISIL Ratings Limited is a wholly owned subsidiary of CRISIL Limited, an S&P Global company).

CRISIL Limited had launched its ESG scoring business in June 2021 with the objective of providing services to clients using a robust India-specific framework on the environmental (E), social (S) and governance (G) aspects. Pursuant to the receipt of the ERP registration, CRISIL Limited has transferred its ESG scoring business to CRISIL ESG Ratings with effect from May 03, 2024.

CRISIL ESG Ratings serves institutional and retail investors, asset managers, lenders and corporates (including issuers) using its proprietary ESG rating methodology to assess companies across sectors.

For more information visit [www.crisilesg.com](http://www.crisilesg.com)

### **About CRISIL Ratings Limited (A subsidiary of CRISIL Limited, an S&P Global Company)**

CRISIL Ratings pioneered the concept of credit rating in India in 1987. With a tradition of independence, analytical rigour and innovation, it has set the standards in the credit rating business. CRISIL Ratings has rated over 33,000 large and mid-scale corporates and financial institutions and has also instituted several innovations in India in the rating business, including ratings for municipal bonds, partially guaranteed instruments and infrastructure investment trusts (InvITs).

CRISIL Ratings is a wholly-owned subsidiary of CRISIL Limited ('CRISIL'). CRISIL Ratings is registered in India as a credit rating agency with the SEBI.

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### **About CRISIL Limited**

CRISIL Limited is a leading, agile and innovative global analytics company driven by its mission of making markets function better.

It is India's foremost provider of ratings, data, research, analytics and solutions with a strong track record of growth, culture of innovation, and global footprint.

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