MORNINGSTAR | SUSTAINALYTICS

THE ESG RISK RATINGS

MATERIAL ESG ISSUE: PRODUCT GOVERNANCE

SUSTAINALYTICS' MATERIAL ESG ISSUE: Product Governance

How companies manage risks related to product governance issues such as product quality and safety, service safety and responsible marketing practices is captured through Sustainalytics' ESG Risk Ratings. Within the Risk Rating framework, Sustainalytics assesses these risks as a separate material ESG issue (MEI): 'Product Governance'. Sustainalytics' assessment of this material ESG issue helps inform investors about the degree of exposure companies face regarding product governance and the extent to which this exposure is managed. This background piece will explore where exposure to this issue stems from, and how companies manage these risks.

The importance of Product Governance

Product and service safety is crucial for any business. Delivering safe and reliable products and services help to maintain customer satisfaction and loyalty and reduces the risk of replacing faulty goods. Research has shown that ensuring customer retention by offering high quality products is profitable in the long-term as existing customers have a 60-70% conversion rate, while new customers have a 5-20% rate[i]. Furthermore, maintaining robust product quality builds brand reputation and minimizes product recalls.

Active product oversight requires quick access to reliable data, continuous monitoring, and collaboration across the business. Companies in highly regulated industries such as healthcare, food & beverage, financials, transportation, and aerospace & defence will need to meet stringent product and service safety standards and meet minimum quality requirements. Failure to do so could result in product liability lawsuits and loss of licence to operate. Companies can reduce these risks by having their operating sites certified to a reputable international quality management standard (QMS) such as the ISO 9001. Sector specific QMS certifications such as the FSSC 22000 for food products, ISO/TS 16949 for automobiles and TL 9000 for telecommunications also help in mitigating quality issues and improve product oversight.

Customers, regulators, and investors are becoming increasingly aware of product governance issues. The Boeing 737 MAX plane crash in Ethiopia in March 2019 brought to light how poor product governance practices can cause significant financial losses and negatively affect brand reputation in the long term. The aircraft manufacturer had accepted responsibility for the crash for having produced an airplane that had an unsafe condition[ii]. This shows the importance of having strong product quality and safety management systems in place.

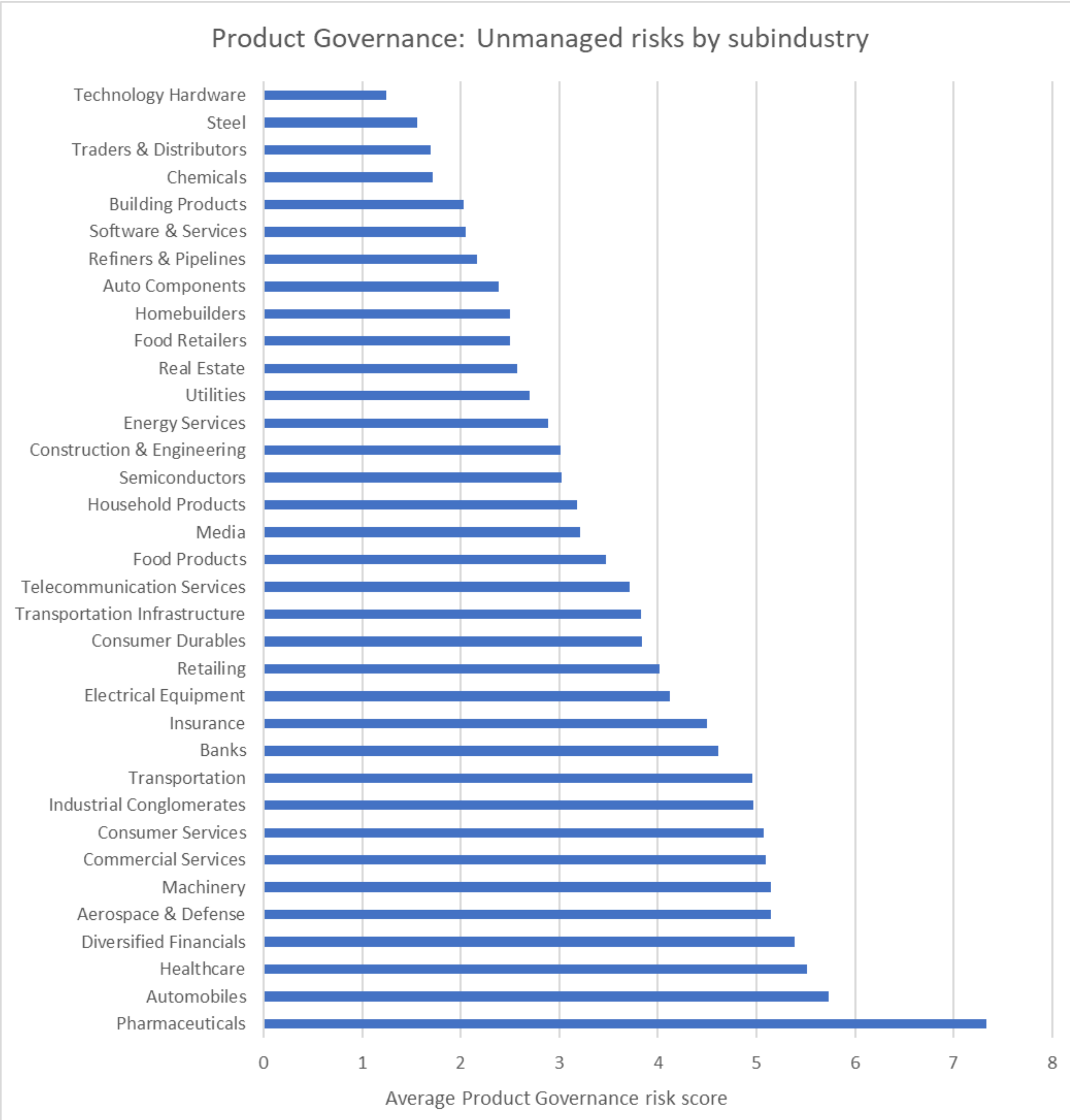
Assessing the Unmanaged Risk of Product Governance by Industry

Companies in sectors such as automobiles, machinery, healthcare, and pharmaceuticals face increased scrutiny from customers and regulatory authorities on the quality and safety of their products and services. Exposure to product governance risks stems from issues relating to product defects, design flaws, poor customer service and equipment malfunction. These in turn could lead to product recalls, lawsuits from affected customers and large compensation payments.

The risk rating for the Product Governance MEI combines the risk a company cannot completely manage due to its business model and product offering with the risk that it is not actively managing due to the lack of implementation of relevant programs and policies. Applying our consistent and comparable ESG Risk Ratings model, we see that the MEI Product Governance is material for 3462 companies in our comprehensive universe, spanning 35 industries. Exhibit 1 shows the average unmanaged risk score for

Product Governance at the industry level in Sustainalytics ESG Risk Rating. Pharmaceuticals peer group has the highest average unmanaged risk score, followed by Automobiles and Healthcare.

Exhibit 1. Product Governance: Unmanaged Risk by Industry



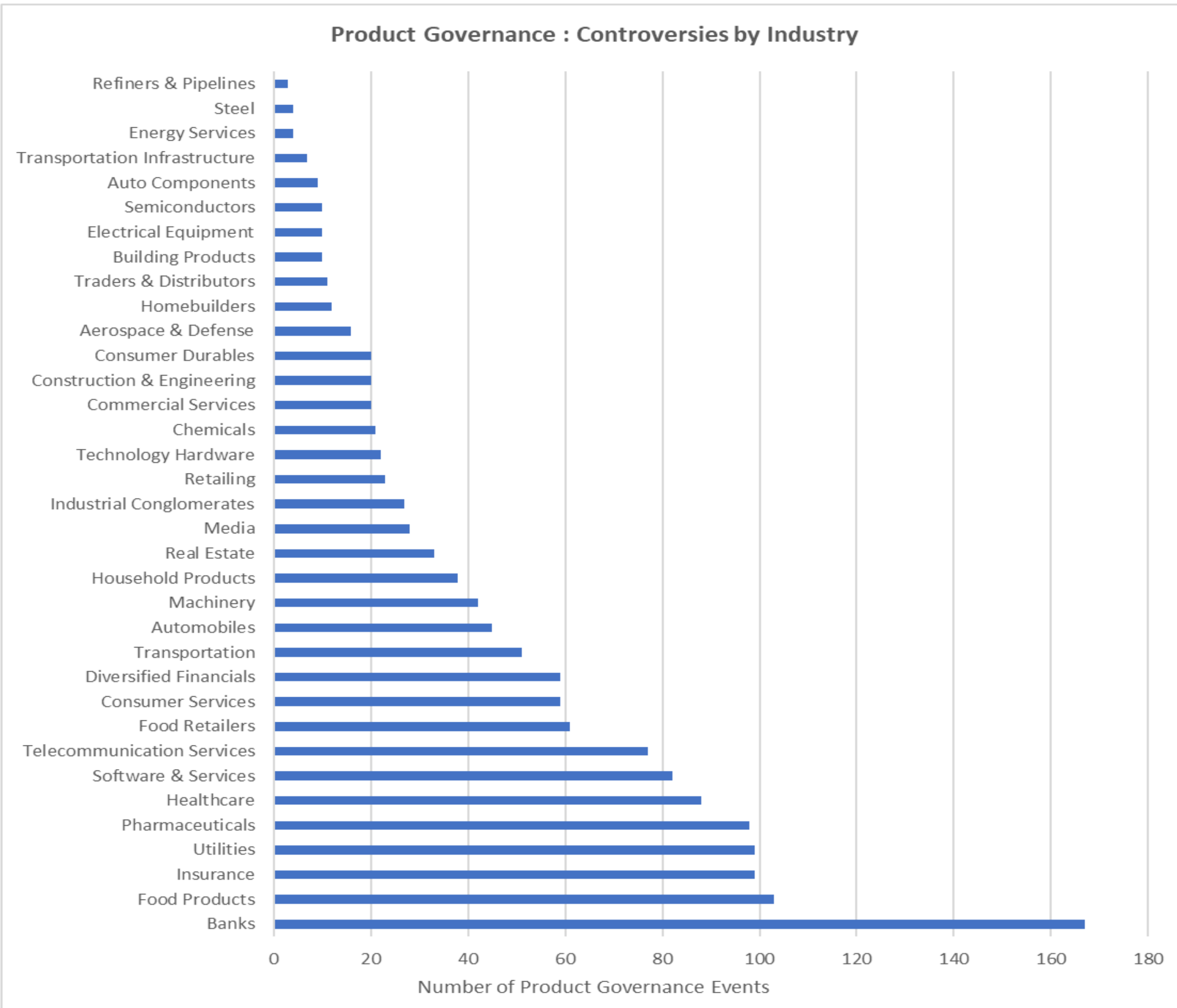
Source: Sustainalytics, data as of January 2022

Within our research we also analyse the involvement of companies in controversies, to ensure that our ratings capture both the company reporting (though the management indicators), as well as third party external data (through our incidents and controversy research) to provide a full picture of a company's ESG performance. Events are assessed on a scale of 1-5 (5 being the most severe) based on impact on stakeholders and business risk. The information is captured through our news screening of more than 700,000 news items, third party sources or company and regulator reporting.

As of January 2022, Sustainalytics recorded a total of 1478 controversies related to Product Governance. We used the following data points as part of our analysis:

- Product Governance MEI: Quality & Safety, Marketing Practices

Exhibit 2. Product Governance: Controversies by Industry



Source: Sustainalytics, data as of January 2022

Exhibit 2 shows the number of events related to product governance across industries. Banks has recorded the highest number of controversies, followed by Food Products and Insurance. Most of the recorded events are related to product quality issues and safety defects that have resulted in product recalls and compensation payments. Companies have also been involved in controversies related to poor marketing practices and services such as false advertising and issuing misleading statements.

How Sustainalytics' evaluates companies on Product Governance

Our ESG Risk Rating framework scores companies on a set of subindustry-specific exposure and management indicators. We consider whether a company has implemented robust product safety and service safety measures. Depending on the subindustry, we assess management practices related to product quality and safety, responsible marketing practices and identify if companies have been certified to globally recognized quality management standards. We also look at formal policies or commitments to ensure product and service safety, which set the scene for the application of programs and enhance strong product governance practices.

Oshkosh Corp, a leading American heavy machinery and truck manufacturer, is a good example of a company with strong management of Product Governance risks. The company discloses a strong product and service safety programme with managerial oversight from its senior director. It reports that each of its business segments has a product safety lead that is responsible for overseeing product safety results. Oshkosh also reports that it has an internal enterprise quality management system to assess product safety risks and standardize product quality management practices across the entire organization. Furthermore, the company offers employees training on product safety and conducts regular external product and service safety audits. Regarding quality management certifications, the company reports that more than 90% of its operating sites have been certified to the ISO 9001 standard. Oshkosh has also not been involved in any incidents related to quality and safety and marketing practices.

Management Indicators	Raw Score	Weight	Weighted Score
Product and Service Safety Programme	100	50.0%	50.0
QMS Certifications	100	50.0%	50.0
Marketing Practices	Category 0	0.0%	0.0
Quality and Safety	Category 0	0.0%	0.0
Weighted Sum			100.0

Source: Sustainalytics ESG Risk Rating Report, Oshkosh Corp.

For Informational purpose only.

As investors, regulators and customers become more aware of the risks relating to product governance, how it affects product sales and customer confidence, companies will face increased scrutiny on how they are addressing these issues in their own operations. Using our ESG Risk Rating framework, investors can clearly see which companies are most exposed to this important issue and how well they are managing their related risks.

Sustainalytics
info@sustainalytics.com
www.sustainalytics.com

---

[i] https://www.convinceandconvert.com/online-customer-experience/customer-retention-not-acquisition/

[ii] https://www.theguardian.com/business/2021/nov/11/boeing-full-responsibility-737-max-plane-crash-ethiopia-compensation

MORNINGSTAR | SUSTAINALYTICS