THE ESG RATING AND RANKING INDUSTRY
LESS IS MORE

I investigated 218 different Environmental, Social and Governance (ESG) initiatives and interviewed 45 asset owners, asset managers and companies in the Netherlands, the UK and Germany. Given that this industry serves as an (ESG) intermediary between companies and investors, its importance should not be underestimated. One of my findings is that the sheer amount of ESG ratings and rankings causes reporting fatigue among companies.

By Stephanie Mooij

The rating and ranking industry

We have all heard of Sustainalytics and MSCI, who have quickly expanded their coverage by acquiring small rating companies or by forming partnerships with others. There are, however, many other ESG ratings and rankings that regularly send requests or questionnaires to companies.

Digging a little deeper, one finds that there are hundreds of initiatives. You will also find that there is a lack of convergence between ratings and rankings. They vary widely, conditional on the audience that they are looking to serve and the criteria that they consider. Ratings often consist of hundreds of indicators, making the aggregate score a rather noisy proxy for ESG performance. Making matters worse are the subjective weights allocated to the different dimensions of ESG. This obviously spreads confusion among practitioners. An example is the fact that Volkswagen was announced industry leader, right before the diesel scandal came out. This raises the question of how much we can really tell from the way a company fills out the questionnaire that their rating is based on. Perhaps this questionnaire merely reflects the intentions of a company rather than its actions. Or perhaps some companies have an advantage, because they have the resources to hire people who know how to tick the right boxes.

Reporting fatigue

The Rate the Raters initiative by SustainAbility finds that, out of 108 organizations, about 60% rely completely or partially on information submitted by companies. They may send questionnaires, ask for interviews or even visit them on-site. If you consider that there are currently at least 249 different products that rate, rank or index these companies, it is not difficult to imagine that this becomes burdensome. If 60% of those need you to submit information, this translates to 149 organizations with questionnaires and often opaque methods of assessment! Companies need at least half-to a full-time post to respond to the many requests that come in. This is on top of the work they already put into their sustainability reporting, answering ESG-related investor inquiries and the applications for ESG awards.

It must be noted that there are benefits that come with the ESG rating and ranking industry as well. The questions, for example, provide a helpful way to identify improvement points, progress and as a benchmarking tool. Sustainability managers also tend to use input from raters and rankings to push the ESG agenda internally. They claim that this is necessary because of the lack of questions relating to ESG from mainstream analyst.

Concluding remarks

Billions of dollars in capital are allocated based on the judgement of the ESG rating and ranking industry. This industry has become an intermediary between investors and companies when it comes to ESG. This is not surprising, as investors tend to screen hundreds of stocks on ESG performance. Quantitative metrics thus make this process all the more efficient. However, there are now too many intermediaries with too many different opinions. This has become burdensome (and inefficient) for companies as they need to pour their ESG information into all the different standards that exist today. It would be more practical to implement a focused approach and to clearly communicate this. What ratings or rankings are mostly used by investors? In many cases this would be MSCI or Sustainalytics. Which ones are most aligned with our business? For example, a heavy water user may find it important to participate in CDP water. If these choices are also clearly communicated, it can give a company more focus and more credibility. It is time for companies to put their foot down and decide what is important to them.

As to the investors, they should be aware of the pitfalls of blindly relying on scores, but also of the reporting fatigue it causes. They should have a conversation with their portfolio companies about ESG and materiality. The ESG rating and ranking industry is not a substitute for a conversation, but rather a starting point.

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