The responsibility of ESG ratings

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The explosion of activity around Environmental, Social and Governance (ESG) topics in recent years goes hand in hand with the rising demand for corporate ESG data and information. This demand is mainly driven by the increase in soft and hard ESG regulation globally, as well as the surge in Sustainable investment within all asset classes. In Europe, ESG considerations are now part of institutional investors' fiduciary duty, a big shift compared to the early days of Socially Responsible Investments during the 2000s when ESG was a compliance or a "nice to have" exercise. ESG investment is growing in all major markets, and a key challenge lies in obtaining quality corporate ESG data that will enable investment professionals to evalu-ate and quantify a company's performance with respect to ESG criteria. And that's where ESG ratings come to play, as a prominent product offering within the flourishing market of ESG data.

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The jury is out on whether all investment products labeled as "ESG" today actually promote "true" Sustainability, but everyone agrees that ESG raters are playing a key role in the investment community's assessments of corporate ESG performance. In this sense, ESG raters share the responsibility for a sustainable present and future. Before delving deeper, it would be useful to dispel the common misconception that ESG "ratings", "rankings" and "indexes" are similar. An ESG rating evaluates and scores, typically alphanumerically, a company based on an objective set of pre-defined ESG criteria. An ESG ranking compares a company's ESG performance relative to other companies, usually against a given set of ESG criteria. An ESG index tracks the trading value of a select set of company stocks (securities) that meet pre-defined ESG criteria relative to specific markets or sectors, and is used as a benchmark for investment offerings, such as funds.

Investors, banks, and insurance companies are regularly using ESG ratings in pre-investment or pre-debt issue assessments, during engagement with companies, or to assess or rate the "sustainability" of an index, fund, or bond. Competition in the ESG raters' sector is fierce and a surge of acquisitions during the past five years has merged ESG specialty rating companies with traditional investment research and data providers in a race to gain deeper expertise and larger market share. Leading ESG rating vendors today are MSCI, Sustainalytics, S&P Global, and Vigeo.Eiris (part of Moody's ESG Solutions). Refinitiv ESG, recently acquired by the London Stock Exchange that also owns FTSE Russel, is another important player in the ESG data market, even though it does not produce a specific rating.

Today, ESG raters are competing on who has the best methodology and who produces the most reliable scores. In the race to stand out, some data providers have given free access to their top-line ESG-related ratings (MSCI, S&P Global) and more insight into their methodologies. However, comparability of ESG ratings is an issue, not least because of differences in methodologies, sophistication, and purpose. For example, based on what the rating measures, the European Securities and Markets Authority has introduced a helpful grouping of ratings into two broad categories: ESG risk and ESG impact ratings. ESG risk ratings measure exposure to ESG risks and relevant management practices; ESG impact ratings measure the impact of an enterprise on ESG factors. In addition, ratings may assess the entire range of ESG topics, a subset of ESG topics (for example only the "E" of ESG) or be topic specific measuring risk or impact relevant to one topic (i.e., climate or water).

Notable research has indicated considerable misalignment between scores of the same company produced by different raters. On the quest for comparable complete, consistent, comparable, and reliable corporate ESG data and information this disagreement is the cause for alarm and frustrations of investors and corporates. In fact, institutional investors agree that ESG ratings are rarely the single source in the assessment of a company's ESG performance and are mainly used as auxiliary to their own engagement and analysis. And corporates often wonder about the black box that their ESG data goes into that produces varying results from different vendors. On the other hand, ESG raters are increasingly arguing that comparability is not their objective, but rather to reflect the individual rater provider's evaluation of "how a company manages its operations and its relationships with various stakeholders in terms of both corporate financial outcomes and broader societal impacts." (Global Head, Sustainable Investing Research, Morningstar)

Ideally, an ESG rating should provide an objective measure of how a company is performing against a sustainable benchmark, which is defined by environmental and social thresholds and criteria; in this sense the rating would determine whether a company operates not simply by avoiding environmental and social deterioration or complying with regulatory boundaries or social norms, but also, if possible, by assessing if, and how much, it creates positive outcomes. This goes beyond the simple practice of identifying a "best in class" or a "who does less bad" rating, to creating a benchmark that scores against absolute and objective criteria. That creates a responsibility on behalf of ESG raters to create a benchmark and methodology that reflects "true" Sustainability.

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ESG raters are not regulated today, but there are signs from certain jurisdictions – notably the EU – that some regulation is being considered, especially since the data they provide feeds into investable products. The ESG data market will inevitably evolve alongside ESG disclosure standardization that is currently underway, but the biggest challenge facing raters is ensuring that their products translate unstructured data into actionable insights for the capital markets, and drive "true" Sustainability.