Top 5 tools to manage ESG ratings and keep up with the speed of change in ESG

"ESG is changing so fast!": the same sentence that rang true several years ago could not be more relevant today. ESG disclosure requirements have increased by the year, and, in turn, companies like Novartis have accelerated their own ESG strategy governance and practices. Current changes bring entirely new complexities as legislation makes ESG no longer voluntary, yet years of engagement with ESG rating agencies have fashioned tools companies can employ as they embark on the journey towards legislative readiness.

By Ana-Maria Tolbaru

Tool #1: Prioritization

Just like the emergence of multiple ESG-related regulations now, the past few years have seen a rapid increase in the number and types of ESG ratings, be they risk- and risk-management-driven like MSCI or Sustainalytics or impact-focused, centered on a single topic such as carbon risk or entirely niche, such as business air-travel-only ratings. Having a variety of agencies assess different ESG aspects was welcomed, however multiple assessments have made it difficult for companies to sieve through disclosure requests. To determine which ESG ratings are most relevant, Novartis runs a regular prioritization exercise. Typically starting with desk research, the first phase generates a longlist of rating agencies. This is then screened across various dimensions, such as: relevance to the company's ESG strategy, materiality, internal resources required, methodology soundness, transparency, influence on stakeholders or reputation.

Tool #2: Mapping all requirements in one table

Tracking several ESG ratings means disclosure gaps need to be identified for requirements by all priority agencies. Novartis has typically defined gaps as the information requested and considered best practice by the rating agency vs. the information already publicly disclosed. As simple as that may sound, this is a substantial first hurdle. The European Commission's targeted consultation on the functioning of the ESG ratings market in the European Union, held between April and June 2022, found most respondents (81%) considered the current level of correlation of ESG ratings, i.e. ratings assessing the same sustainability aspects, as "not adequate".

Indeed, beyond having different methodologies, each agency also "nests" its requirements into questions that are uniquely phrased and living in sub-categories and categories that vary widely. This lack of comparability is worsened by the different formats: some agencies opt for online platforms accessible with unique usernames (e.g., S&P Global), other opt for Word or PDF documents (e.g., Sustainalytics).

When it comes to identifying gaps, the goal is to be able to search for a specific topic across all rating agencies and get a quick snapshot as to how the different disclosure requirements on the topic live up within the company's published content. Given that the only format to which one can apply such a search & filter function is a table, this means the first step in addressing gaps can well be bringing all requirements into a table, ordered by easily searchable topics, or common denominators. The process, unwieldy in a first instance due to the amount of manual input, becomes easier in time as it typically requires annual maintenance.

Tool #3: Deep knowledge of the methodology

At the very core of addressing ESG rating gaps lies a deep understanding of the ratings' methodologies, with the devil often in the details. One could find that a company's practices may address the essence of a rating's question, but still not entirely fit the methodology's more reductive categories. The task is not without complexity: in the case of CDP alone, the number of reference documents one needs to be aware of per question include reporting guidance, scoring methodology, scoring introduction and questionnaire changes, to mention a few.

Tool #4: Allocation of gap severity levels

One way to tackle gaps is initially through individual stakeholder workshops with all the relevant business functions, such as Environmental Sustainability or Enterprise Risk Management. The recipe for successful gap-closing workshops involves a deep understanding of the requirement and, to provide further context, an understanding of peers' practices. The severity of gaps varies, and different maturity levels require different approaches. Internal workshops can conclude that the company has the information requested, but not always in the exact form requested by a rating agency, or sometimes not in a public document. Or, that there is a real gap, a requirement to which existing practices, policies or strategies are not already aligned. In the latter case, gaps are then brought to the attention of various internal stakeholder groups, including senior management, as needed.

Tool #5: ESG accountability throughout the organization

This might as well be Tool #1. The improvement of Novartis in ESG ratings over the years would not have been possible without having accountability for ESG throughout the organization. It is often heads of departments who are directly involved in responding to ESG requirements and raising the bar internally on sustainability. The process of closing gaps is further strengthened by governance structures, which include multiple ESG-focused committees at senior management and Board of Directors levels. Having such accountability structures is also one of the five pillars mentioned by George Serafeim in his five-pronged approach for companies to better manage and govern resources allocated to ESG issues and it is, ultimately, the first must-have (see box). As the saying goes: one can't make bricks without straw.

*** All views expressed in this article are solely those of the author and do not necessarily reflect the views of the author's employer.**

GEORGE SERAFEIM'S FIVE-PRONGED APPROACH TO MANAGING AND GOVERNING RESOURCES ALLOCATED TO ESG ISSUES:

1. Think of ESG as strategy not as compliance
2. Create accountability for ESG throughout the organization
3. Identify a corporate purpose and build a culture around it
4. Give ESG responsibilities to core business leaders
5. Use impact-weighted accounting metrics for better decision-making and to attract aligned investors

See George Serafeim, "Social-Impact Efforts That Create Real Value", in *Harvard Business Review*, September/October 2020.

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