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ESG ratings: From fog to sunshine?

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Abstract

Companies increasingly communicate ESG ratings and investors increasingly use them. ESG ratings are useful for several reasons (as a tool to monitor ESG performance, for example) provided there is transparency regarding the meaning of the particular ESG rating (What does it rate? What is the methodology applied? etc.). Currently, transparency in this regard is rather weak as ESG rating agencies use multiple objectives, methodologies and scores. Regulators in multiple jurisdictions are trying to improve this situation. We briefly present the proposed EU Regulation on rating activities requiring authorizations, separation of rating activities and related business, communication, and transparency.

Keywords: ESG rating, rating objectives, rating methodologies, EU regulation on rating activities

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ESG ratings: From fog to sunshine?

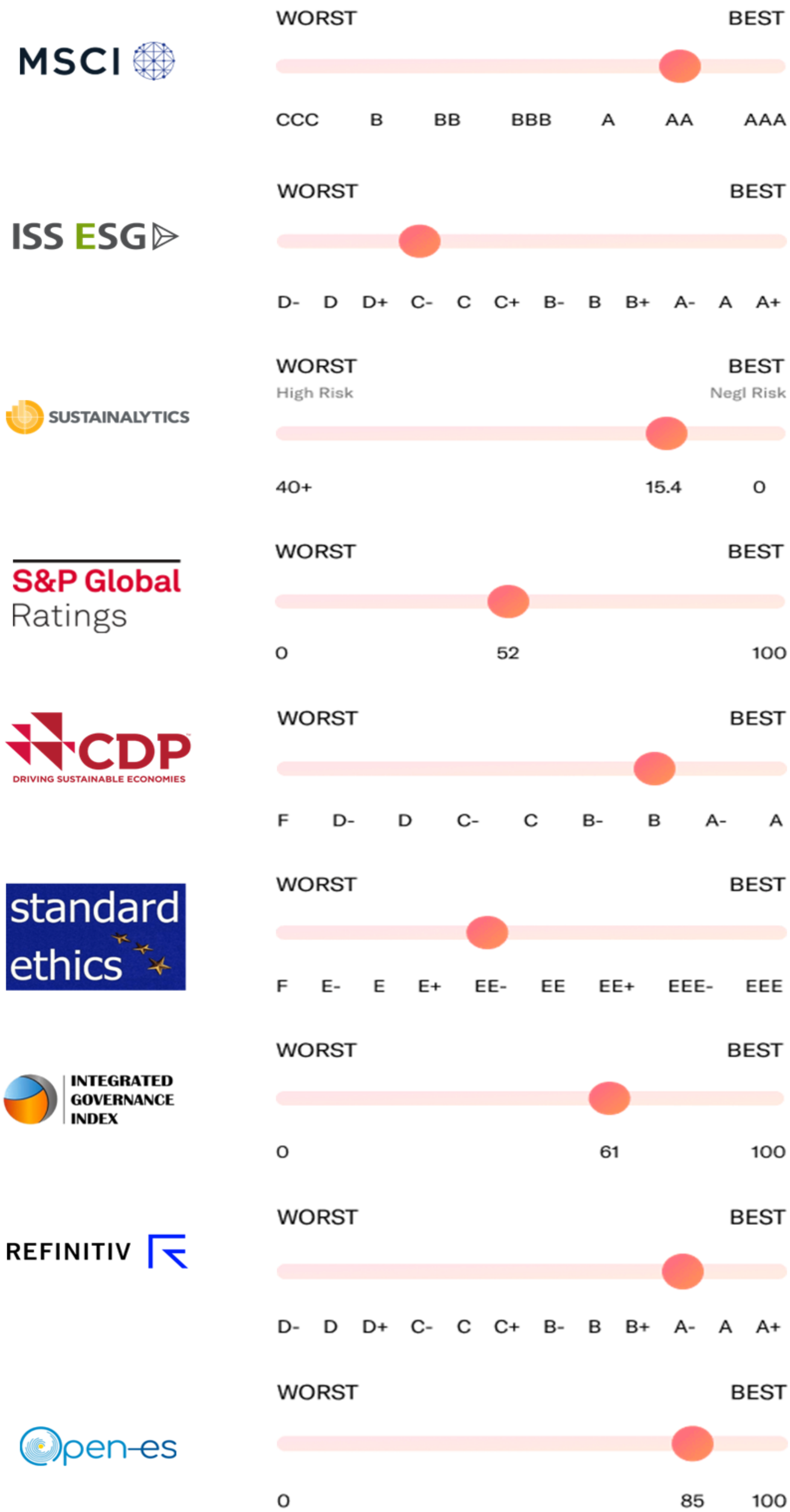
Introduction

Browsing the website of the German car manufacturer BMW you can find in the “investor relations” section the credit ratings for BMW. In March 2024, the long-term rating is A for S&P and A2 for Moody’s, the short-term rating respectively A-1 (S&P) and P-1 (Moody’s). The two ratings indicate the same (low) credit risk class for BMW notwithstanding the rating agency.

On the same webpage, right next to these credit ratings, BMW also communicates four sustainability ratings: AA from MSCI ESG, A-list from CDP Climate Change, Prime, C+ from ISS ESG, and 24.8 from Sustainalytics. We notice first that the scale used is different and further enquiries show that these ESG ratings do not put BMW in one category but in several. AA from MSCI ESG is the second highest rating, A-list from CDP is the highest rating, 24.8 from Sustainalytics is a third-class rating. The confusion is complete when we look at ISS ESG: they consider BMW as “Prime” because their ESG performance is above the sector-specific threshold, which means that they fulfil ambitious absolute performance requirements (ISS ESG 2023), but at the same time C+ which is a medium rating (7th best rating)?

If we have a look at other companies from different industries, we obtain similar situations. Figure 1 presents the different ESG ratings for Illimity Group, an Italian high-tech banking group, headquartered in Milan (Italy) and listed in the STAR segment on the Italian Stock Exchange (Borsa Italiana). All the ratings refer to 2023, except CDP (December 2022) and Open-Es (July 2022). From this picture, it can be easily noted not only the big differences in the evaluations, but also the distinct scales and metrics used by the different ESG rating companies.

Figure 1 - Illimity Group ratings from different ESG rating companies



(Source: https://www.illimity.com/en/sustainability/esg-rating-and-indices - Last accessed: April 15th, 2024)

These examples clearly illustrate that the current ESG rating landscape is quite unorganised, with a multitude of ESG rating agencies (much more than credit rating agencies) who use very different scales, and opaque (What do rating providers actually rate? What are their methodologies? etc.). This lack of comparability is obviously a problem as they obscure, rather than clarify the situation of the rated company. The purpose of this paper is to shed some light on the current fog of ESG ratings and to show the "EU way" into the sunshine of more transparent and comparable ESG ratings.

The usefulness of ESG ratings

An increased focus on issues such as climate change and employee rights violations has triggered a change in the business sentiment, requiring practitioners and academics to rethink the issue of corporate value creation and purpose. This has culminated in what is commonly referred to as stakeholder theory. According to this theory, the impact of business actions on a broader set of stakeholders, ranging from the nearby river and the neighbour to the investor, should be considered. However, measuring the impact of corporate operations on various stakeholders is tricky for various reasons, including limited data access to comprehensive information regarding companies' sustainability practices. Furthermore, the absence of a consistent measurement methodology makes an effective comparison across companies and industries challenging.

Several initiatives, including the Global Reporting Initiative in 1997, the Carbon Disclosure Project in 2000, the Sustainability Accounting Standards Board (SASB) in 2011, the Taskforce on Climate-related Financial Disclosures (TCFD) in 2015, and the Workforce Disclosure Initiative in 2016 have contributed to the development of measurement systems to monitor corporations and motivate them to act more sustainably. The established frameworks have led to a variety of proposed measures of corporate sustainability aiming at improving transparency and comparability. In parallel, index-providing rating agencies such as MSCI, Sustainalytics, RepRisk, or ISS have created their own ratings of corporate ESG performance.

ESG ratings are useful to various interested parties because they provide a measure of ESG-related activities that is quantifiable and thus supposedly allows for comparability of corporate ESG performance relative to benchmarks. Investors can apply ratings to better assess investment risks and vulnerability to potential regulatory tightening. In addition, ESG ratings help them screen the market for companies that align with their personal values and goals. Using Chinese publicly listed firms, Zhang et al. (2024) find that higher ESG ratings attract liquidity via increased market attention and transparency. Managers use ESG ratings to communicate sustainability-focused efforts to stakeholders if those ratings provide some sort of verification of these efforts. ESG ratings enrich well-performing companies with access to a broader pool of investments, for instance enabling them to issue specialised financial instruments such as Green Bonds. Regulators use ESG ratings to measure regulatory compliance or as a basis for new regulatory advancements. And, overall, ESG ratings contribute to solving ongoing issues such as the climate crisis by shifting market sentiment and attention towards those issues.

The above-described usefulness of ESG ratings however hinges on several factors affecting how ratings are compiled, communicated, and interpreted. An important assumption is that the underlying data is available and reliable. Companies reporting incomplete or misleading data can affect the accuracy and relevance of the ratings. The reliability of ESG ratings also hinges on an ESG rating consensus. For instance, Serafeim and Yoon (2023) find that the predictive power of ESG ratings significantly decreases in rating disagreement. Second, communication of ESG ratings and ESG-related activities must be unbiased, with both bad and good news being reported, avoiding the concern of greenwashing.

Lastly, ESG ratings will be most useful when stakeholders are willing to base their decisions on them. Investors focusing on long-term improvement in performance despite sacrificing short-term gains will receive the largest benefit from ESG ratings. Managers willing to adjust business processes and adopt changes in the organisational culture will most likely benefit from communicating ESG ratings to stakeholders. For instance, using evidence from Italian firms, Clementino and Perkins (2021) find a wide range of corporate reactions to being rated from conformity to resistance. Similarly, ESG ratings will have the highest utility in robust and transparent regulatory environments.

The current situation of ESG ratings

Variations in stated objectives of ESG ratings

The ESG rating industry is currently highly fragmented.

While initially, the purpose of ESG ratings was to provide a reliable and consistent measure of corporate impact on its stakeholders, no official definition exists (ESMA 2021). Notably, the lack of a coherent definition is described as part of the process of developing sound ESG ratings, "a logical progression of our field's evolution and thinking. New issues emerge, the breadth and depth of our impacts are better understood, and we all want to know a little bit more." (Wallace 2020). ESG ratings merely represent the unbinding opinion of ESG rating agencies. In addition, there is no binding definition of the methodology to be applied. With over 600 different rating agencies operating on the market (ESMA 2021), it is no wonder that a variety of different methodologies and scores exist. According to Christensen et al. (2022), improvements in ESG disclosure and a higher availability of related information have contributed to an increasing diversity in ESG ratings.

This difference is illustrated in the following table, which compares the stated objectives of several ESG rating firms (Larcker et al., 2022).

Table 1 – Examples of objectives of ESG ratings

Stated objectives of ESG rating	**Assumptions behind the stated objectives of ESG rating**	**Examples from ESG rating companies**
Reduce risk	ESG quality improves financial performance by reducing ESG risks to a company's business model or operations.	MSCI claims its rating "supports ESG risk mitigation and long-term value creation."
		Sustainalytics measures "the degree to which a company's economic value is at risk" due to ESG factors.
Predict returns	When calculating the ESG score of a company, the rating model will only use	HIP claims that its ratings "correlate with better returns for the same amount of risk"

Stated objectives of ESG rating	Assumptions behind the stated objectives of ESG rating	Examples from ESG rating companies
	information that significantly helps explain future risk-adjusted performance.	Arabesque says its approach "is all about identifying companies that are better positioned to outperform over the long term."
Measure a company's environmental or social impact	ESG ratings assess a company's ESG impact across its entire operation.	ISS ESG Corporate Ratings "evaluate companies' ESG-related risks, opportunities, and impact along the corporate value chain".
Measure a company's transparency and commitment to ESG	ESG ratings are designed to transparently and objectively measure a company's relative ESG performance, commitment and effectiveness.	"LSEG ESG scores reflect the underlying ESG data framework and are a transparent, data-driven assessment of companies' relative ESG performance and capacity, integrating and accounting for industry materiality and company size biases".
Provide a screen for ESG selection in support of responsible management	Scores allow investors to understand a company's exposure to, and management of, ESG issues in multiple dimensions.	FTSE Russell

Variations in ESG rating presentations

ESG ratings are presented in various formats. Some companies such as MSCI use a 7-point scale from leader (AAA, AA) to laggard (CCC, B) with A-, BBB and BB labelled as average. Some companies (such as ISS ESG Corporate Rating) use a 12-point scale from A+ to D-. CDP, formerly known as the Carbon Disclosure Project, also uses a A+ to D- system, but if a company is invited to participate in the CDP rating and chooses not to respond, this company will receive an F score.

Another widely applied scale is a score from 1 to 10 (decile basis) and from 1 to 100 (percentile basis), where 10 (decile basis) and 100 (percentile basis) can either represent highest quality, best performance, most positive, most transparent (such as Bloomberg) or most negative, highest ESG risk, lowest disclosure quality (such as ISS ESG E&S quality score).

On the other hand, ESG ratings can be an indication of the level of risk. For instance, Sustainalytics categorises companies across five risk levels (scores) (figure2).

Figure 2 - Morningstar Sustainalytics' ESG Risk Ratings

Negligible	Low	Medium	High	Severe
0 - 10	10 - 20	20 - 30	30 - 40	40+

(Source: https://www.sustainalytics.com/esg-data - last access: April 15th, 2024)

Furthermore, when using the ESG ratings, investors need to carefully differentiate whether the rating is industry-adjusted or not. Industry-adjusted ratings allow investors to compare ESG quality across firms of the same industry but should not be used for the evaluation of firms from different industries. These ratings are sometimes referred to as "best in class": a company gets a high rating if its ESG quality is comparatively high in the industry. That is how a company from a polluting industry (oil and gas, for example) can still get a top rating – if it has higher ESG quality than its industry peers. On the other hand, ESG ratings that are not industry-specific can be used for the evaluation of firms across industries. These ratings measure absolute ESG quality.

Variations in methodologies

To derive an overall ESG score, rating firms usually develop their own ESG rating frameworks and make individual assessments of the E, S, and G components separately. For instance, MSCI (2024) assesses the performance of a company on 33 ESG issues through public data, including media sources, government and NGO datasets, and the company's own disclosures. The 33 ESG issues identified can be categorised as 33 subcomponents under three fundamental pillars of the rating frameworks: Environment Pillar (including climate change, natural capital, pollution and waste, environment opportunities accountable for 13 issues out of the 33 subcomponents), Social Pillar (including human capital, product liability, stakeholder opposition, social opportunities issues accountable for 14 issues out of the 33 subcomponents) and Governance Pillar (including corporate governance and corporate behaviour issues accountable for 6 issues out of the 33 subcomponents). These 33 subcomponents might be derived using statistical analysis of historical data or they may be hypothesised based on a theoretical relation. Only issues that MSI deems material to a company are scored. MSCI ESG Ratings research aims to answer two questions. The first question is: Of the negative externalities that companies in an industry generate, which issues may turn into unanticipated costs for companies in the medium- to long-term? The second question is: Conversely, which ESG issues affecting an industry may turn into opportunities for companies in the medium to long term?

While different rating companies employ different approaches to arrive at an overall ESG rating score, they all use a large number of input variables. Bloomberg covers more than 120 ESG indicators and does not customise its approach by industry or sector. On the other hand, ISS ESG's E&S Disclosure quality score covers 380 environmental and social factors which vary by industry group. ISS also publishes an industry-adjusted Governance Quality Score that considers 200 factors related to board structure, compensation and remuneration, shareholder rights, and audit and risk oversight.

With more than 600 ESG ratings published globally, each with its own methodology, scoring, and target audiences, it can be hard and confusing for investors to know which ESG ratings to rely on.

How to improve the usefulness of ESG ratings

As shown above, there is currently a clear lack of transparency of ESG rating methodologies and objectives, which results in reduced reliability. This lack of transparency impairs the usefulness of ESG ratings for the functioning of financial markets. There is also a risk of greenwashing, which could hamper the trust of investors in sustainable investments. Consequently, in several jurisdictions, such as the EU, the UK, Japan or India, proposals to regulate ESG rating activities and/or for a code of conduct are being discussed. In the following paragraphs, we focus on the EU situation.

An important part of the "European Green Deal" (2019) and the EU Action plan "Financing Sustainable Growth" (2018) aims to use financial markets to channel capital to sustainable investments. The EU Commission mandated a "Study on Sustainability - related ratings, data and research" that was published in November 2020. Based on the results of this study the "Strategy for financing the transition to a sustainable economy" (2021) announced policy initiatives on ESG ratings. In June 2023 the EU Commission published a proposal for an EU regulation "on the transparency and integrity of Environmental, Social and Governance (ESG) rating activities". This ESG rating agency regulation takes example from the EU regulation 1060/2009 regarding credit rating agencies. The Council of the EU and the EU Parliament in February 2024 reached a provisional agreement on the proposed regulation (Council of the EU 2024). The text needs formal approval by both bodies before going through the formal adoption procedure.

The main elements of the proposed EU regulation to enhance the comparability and reliability of ESG ratings are:

- EU ESG rating agencies need to obtain authorization to operate from the European Securities and Markets Authority (ESMA). Non-EU ESG rating agencies either need an endorsement of their rating from an EU rating agency or can operate because of an equivalence agreement (discussed between ESMA and the relevant third-country authority). In case of violation ESMA has the power to impose penalties. Small, already existing rating agencies get temporary relief from the full authorization requirements to facilitate their market entry. The authorization to operate can be withdrawn or suspended. To obtain authorization ESG rating agencies must provide certain information such as the number of analysts involved in the ESG rating and their experience and training, or the expected market coverage of the ESG rating.

- ESG rating agencies will be subject to a principle of separation of business and activities, requiring either different legal entities for different activities (ESG ratings AND sustainability consulting services, credit ratings, or audit services for the same client) or clear separation measures (Chinese walls between the credit rating and ESG rating activities, for example) to avoid conflicts of interests.

- Financial market participants who use ESG ratings in their financial communication must provide information on their website.
Annex III of the proposed EU regulation lists the 30+ information items, covering the organisational set-up, the rating governance, and methodological details (for example, whether the E factor takes into account the Paris Agreement). This information should be disclosed for each rating product, meaning that Moody's, for example, needs to provide their 200 methodologies for their around 40 different ratings, or S&P around 350 methodologies, all updated every year. The methodology should be based on a double materiality approach. Information about models and key assumptions are also required here. The above information must be provided separately for E, S and G.

- Ratings can be provided for E, S and G separately (preferred by the EU) or for ESG altogether. In the latter case, the weight of the E, S and G part must be indicated.

Despite the above measures, it is likely that ESG ratings will not achieve the same degree of comparability as credit ratings. Indeed, the content of credit ratings is by its nature relatively standardised: every credit rating looks at financial statements-based profitability, solvency, and liquidity (plus country risk and other elements). Although different ratios with different definitions can be applied in these three areas, there is a common understanding about the meaning of profitability, solvency, and liquidity. This common understanding is more difficult to achieve for ESG ratings.

First, what is relevant (material) in the E, S, and G area depends on the stakeholders you consider. Whereas for credit ratings only creditors (short-term and long-term) are considered stakeholders, the potential ESG stakeholder scope is much wider and more diverse (unions, communities, clients, suppliers, etc.). Hence, it is more difficult to agree on a common understanding: Is gender equality more important for the S (or G?) score or are general working conditions (health and safety)?

Second, even if a common understanding of the material items could be achieved, for example, water consumption in the E area or corruption-avoiding rules in the G area, there would still be an issue about how to measure this factor: absolute water consumption or relative (per product, per tonne of production, per € of sales revenue, per € of gross margin); freshwater or saltwater consumption; consumption in water-stressed areas, areas with water-scarcity or areas with water-surplus, etc.

Conclusion

While ESG ratings are undoubtedly growing in importance and attracting increasing attention from the markets, practitioners, and academics, the current landscape is undeniably confusing and fragmented, due to the lack of standardised methodologies, non-comparable differentiated scales, and diverging objectives among the different stakeholders. This ambiguity not only harms the usefulness of ESG ratings and their informative contribution to the market but could also potentially create a fertile ground for greenwashing practices, with further erosion of trust in sustainable investing.

However, some winds of change seem to be blowing away the current fog. The role of regulators and governments might be crucial in this circumstance. Some initiatives, like the proposed EU regulation on ESG rating activities, could lead the way to transparency and accountability. By mandating clear disclosures on methodology, mitigating conflicts of interest, and establishing oversight mechanisms, these regulations aim to bring much-needed sunshine to the foggy domain of ESG ratings.

However, the path forward is definitely not without its challenges. Unlike credit ratings that focus on the relatively standardised realm of financial statements, ESG ratings have to cope with their intrinsic complexity: from the application of the "materiality principle" to effective measures amongst different stakeholders.

Despite these challenges, the growing focus on ESG considerations at all levels requires increasing efforts towards more robust and reliable ESG ratings. At present, the future of ESG ratings is far from certain, but with ongoing efforts towards transparency and standardisation, they have the potential to emerge from the fog and illuminate the path towards a more sustainable financial system.

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