Finance Watch

Making finance serve society

Regulating ESG ratings to strengthen sustainable investors

A Finance Watch Policy Brief

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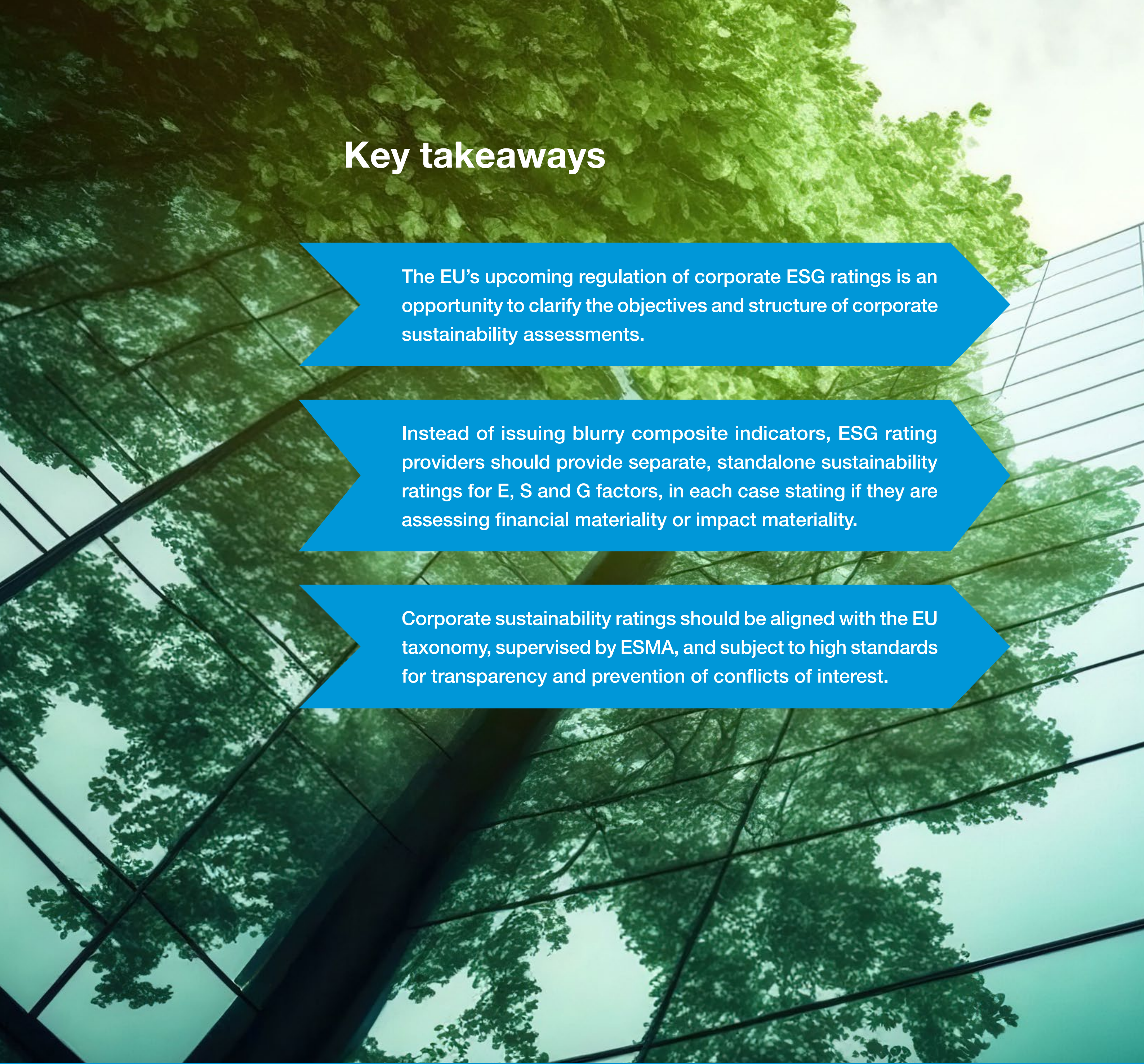

Key takeaways

The EU's upcoming regulation of corporate ESG ratings is an opportunity to clarify the objectives and structure of corporate sustainability assessments.

Instead of issuing blurry composite indicators, ESG rating providers should provide separate, standalone sustainability ratings for E, S and G factors, in each case stating if they are assessing financial materiality or impact materiality.

Corporate sustainability ratings should be aligned with the EU taxonomy, supervised by ESMA, and subject to high standards for transparency and prevention of conflicts of interest.

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Executive summary

The debate around ESG investing has become fraught with confusion and confrontation stemming from the lack of clarity about what ESG rating is trying to achieve.

Businesses generally assume that ESG investing should focus on the financial consequences of sustainability issues on their accounts, an outside-in approach. Broader society, by contrast, thinks more about the impact that businesses have on society and the environment, an inside-out approach.

The gap between these ‘financial materiality’ and ‘impact materiality’ objectives is an obvious recipe for misunderstanding. Attacks come from right and left, with the self-declared ‘anti-woke capitalism’ camp criticizing ESG investing for disrupting the usual way of doing business, while voices at the other end of the spectrum accuse ESG investing of greenwashing.

This confusion is exacerbated by the structure of ESG ratings, which combine very different environmental, social and governance elements into a single, synthetic score.

The European Commission’s regulatory proposal on corporate environmental, social and governance (ESG) ratings, expected in June 2023, is an opportunity to provide some much needed clarity around the objectives and structure of ESG ratings so they can better meet the needs of ESG investors and support the EU’s transition to a more sustainable economy.

Clarity about the objectives of ESG ratings will also help them to serve as a regulatory tool: some financial supervisors are already using ESG ratings to decide when funds can label themselves as ‘ESG’ or sustainable and central bankers are starting to think about using them as measures of ESG risk.

To assess a company’s ESG performance, investors first need to define their own ESG investing objectives so these can be compared with an assessment of the investee company’s ESG outcomes.

The investor’s objectives might be to assess financial materiality, or impact materiality, or both (the ground-breaking concept of ‘double materiality’ is now a feature of EU sustainable finance law).

The assessment of the company’s ESG outcomes can then be done in-house by the investor, perhaps using data bought from an ESG data provider, or more often by using an externally acquired ESG rating or ESG score.

The bulk of asset managers buy external corporate ESG ratings from specialised providers, often with additional analysis tailored to their needs. There is considerable variation in this user landscape.

Buying external corporate ESG ratings is an easy way for investors to substantiate their claims to be ESG investors. It also allows investment firms to cherry-pick providers whose ESG rating methodologies suit their style of investment (growth, value, momentum…) and so minimize disruption. This practice has little influence on the sustainability of the world but it describes a large section of the asset management market.

Another reason to purchase corporate ESG ratings is to invest on the basis of the anticipated ESG performance of a company. For the ESG rating to have predictive value for the investor, the investor needs to know if it matches his or her own ESG objectives. In other words, does it assess financial materiality, impact materiality, or double materiality.

There is no typical ESG rating at present. ESG ratings can vary widely because of:

- different approaches to materiality. Many ESG ratings providers look only at financial materiality. A few look at double materiality but use different methods to combine the financial and impact elements;
- different methods for weighting and aggregating E, S and G factors into a single rating. The wide variety of aggregation techniques means that ratings cannot meaningfully be compared with each other;
- different approaches to assessing relative or absolute ESG performance. Most providers focus on relative ESG performance, for instance "Best in class" responsible investing, even though this can allow companies from harmful sectors to appear in ESG portfolios, which confuses investors and can lead to accusations of greenwashing. Absolute performance is far more relevant for transitioning the economy to a sustainable path and better reflects the expectations of most retail ESG investors.

With these differences, there is a low correlation between ESG ratings, as each provider is measuring different things with a different methodology.

One common problem with ESG ratings is that when providers aggregate largely unrelated E, S and G factors into a single, synthetic rating (a step that has little theoretical basis), it helps to conceal weaknesses whose later emergence could hurt public trust in ESG ratings.

Another problem is that ESG rating providers are often under-resourced. Some ESG rating providers aim to rate many thousands of companies with only a couple of hundred ESG analysts. Their analysts must rely largely on public data and have little time for site visits or research to understand corporate strategies as compared to, for example, sell-side equity research providers whose ratio of analysts to companies is five times higher. This creates a risk of gross misjudgments that can also damage trust and raise questions about the predictive value of ESG ratings.

ESG rating is a multi-factor exercise with multiple outputs. While 'traditional' credit ratings and equity analysis have only two outputs, namely probability of default and company valuation, an ESG rating needs to look at multiple outputs: the inbound financial risks and returns of the environmental and social factors affecting a company, the outbound harms and benefits that the company exerts on the environment and society, and the impact of the company's governance on all of these.

A key feature of ESG ratings is that they consider financial impacts over the medium- and long-term. This can send messages that are radically different to those from the short-term financial impact assessments of traditional credit and equity analysis. For example, investing in fossil fuel companies this year might be financially rewarding if profits stay high but, in the longer-term, climate change means the value of fossil fuel reserves is doomed under all possible scenarios.

In light of these features, regulation should ensure that ESG ratings are clear about their objectives, are transparent about methodology, and are coherent with the EU Taxonomy and other regulation. They should be based on reliable data and be free from conflicts of interests.

A lack of any of these elements will open the door to suspected or actual greenwashing. Conversely, ensuring their provision through regulation will help ESG ratings to add value to investors and support the allocation of capital to sustainable activities.

Recommendations

Supervision

ESG rating providers in the EU should be authorized and supervised by ESMA. EU investors that use ESG ratings for regulatory purposes should obtain them only from ESMA-supervised providers.

Separate and specific objectives

ESG rating providers should provide separate, standalone sustainability ratings for environmental, social and governance factors. In each case, they should state if they are assessing financial materiality or impact materiality or both. They should not produce combined synthetic ESG ratings.

Taxonomy alignment

Environmental assessments should be linked to the EU Taxonomy Regulation and any meaningful divergences highlighted.

Transparency

For each sustainability rating, ESG rating providers should publicly disclose their methodologies, materiality objectives, data sources, and whether ratings are absolute or relative. They should inform ESG users of which data sources are actually used and whether or not the data has been assured.

Conflicts of interest

ESG rating providers should be prohibited from selling consultancy services to companies they are rating. ESG rating providers should have internal controls and procedures to manage conflicts of interest. ESG ratings provider should not rate their own shareholders. No entity should exercise control over more than one ESG rating provider.

Introduction

On 13 June 2023 the European Commission is scheduled to publish a proposal to regulate the provision of corporate ratings on environmental, social and governance (ESG) matters.

This proposal is most welcome. Experience shows that, in the field of financial services, regulation is indispensable to strike the right balance between business and public interests.

The focus of this policy brief is the ESG rating of companies (corporate ESG rating). It aims to reflect on the main themes at stake and it makes recommendations for the coming European Union (EU) regulation of ESG rating providers to set adequate rules and contribute to a rigorous practice.

With that objective in mind, we approach corporate ESG rating in the bigger context of the development of sustainable finance and ESG investing. ESG rating is a means to an end and the end is ESG investing. Whether developed internally or acquired externally by its users, ESG rating is a tool meant to serve ESG investing. A prerequisite to define what ESG rating should achieve is therefore to define without ambiguity what the objective of ESG investing is.

The debate around ESG investing is fraught with a confusion stemming from the lack of clarity of what it tries to achieve. This confusion feeds in turn the confrontation we are witnessing between proponents and opponents of ESG investing.

This debate does not spare the European landscape. Despite its ground-breaking and unique recognition of double materiality in different pieces of regulation[1] and its subsequent recognition of the equal importance of outside-in financial materiality (i.e. the impact of companies' socio-environment on their accounts) and inside-out impact materiality (i.e. the impact of companies' behaviour, operations and production on their socio-environment), EU financial regulation does not yet define what the objective of sustainable finance or ESG investing is. Is it making sustainability-conscious retail investors gain exposure to sustainable assets? Is it managing and reducing in investment portfolios the financial risks emerging from the planet's environmental and social issues? Is it seizing the business opportunities emerging from the planet's environmental and social issues? Is it limiting the negative impact of businesses on the environment and on society? Is it enhancing the possible positive impact of businesses on the environment and on society? Is it all the objectives combined?

1 In particular: its Taxonomy regulation, its Corporate Sustainability Reporting Directive (CSRD) and its Sustainable Finance Disclosure Regulation (SFDR).

The different categories of actors - issuers, financial market participants, regulators, ESG rating providers, retail investors and civil society organisations – often do not put the same meaning behind the words 'ESG investing' and 'ESG performance'. Corporates and financiers mainly care about the financial consequences of sustainability issues on their accounts, whereas citizens and civil society care about the impact of businesses on society and on the environment. Incidentally regulators, who sit in between the two groups, are aware of the debate but not always convinced that they should take sides and they are often split on the subject within their own ranks. In other words, when business thinks, to a large extent, of financial materiality, the broader society thinks of impact materiality. This is an obvious recipe for misunderstandings and greenwashing accusations. Paradoxically, ESG rating has contributed to feeding the greenwashing confusion with a number of publicised cases of issuers with a high ESG rating based on their ability to manage ESG risk or seize ESG opportunities when retail investors and civil society organisations understood their positive ESG rating as reflecting a positive impact on the environment and on society. The two sides of the debate (ESG investing and ESG rating) are closely intertwined.

Another factor has entered the stage over the past year: central bankers have started floating the idea of using ESG ratings as a measure or a proxy to measure ESG risk,[2,3] and some National Competent Authorities (NCAs) are now using ESG ratings as an indicator to allow funds to label themselves 'ESG' or sustainable. If this trend develops further, it will change the nature of ESG rating which, on top of being an assessment of the ESG performance of the rated entities, will become a tool with regulatory consequences. This adds to the urgency of regulating ESG rating and giving it a rigorous framework. Regulating ESG rating requires to have a clear idea of the objective of ESG investing. As long as diverging expectations co-exist around their objective, ESG investing and rating will not gain retail investors' trust and greenwashing accusations will continue to fly around. Defining with clarity the objective of ESG investing in EU financial regulation would be desirable. This would necessitate, among others, to reopen the Regulation on sustainability-related disclosures in the financial services sector (SFDR).[4] However, this is a topic beyond the scope of the present policy brief and, to our knowledge, not on the agenda of the present European Commission for its mandate ending in 2024. Having said that, if the European Commission reopens SFDR one day, it will need to ensure its consistency with the ESG rating regulation that will have been adopted by then if things go according to plan.

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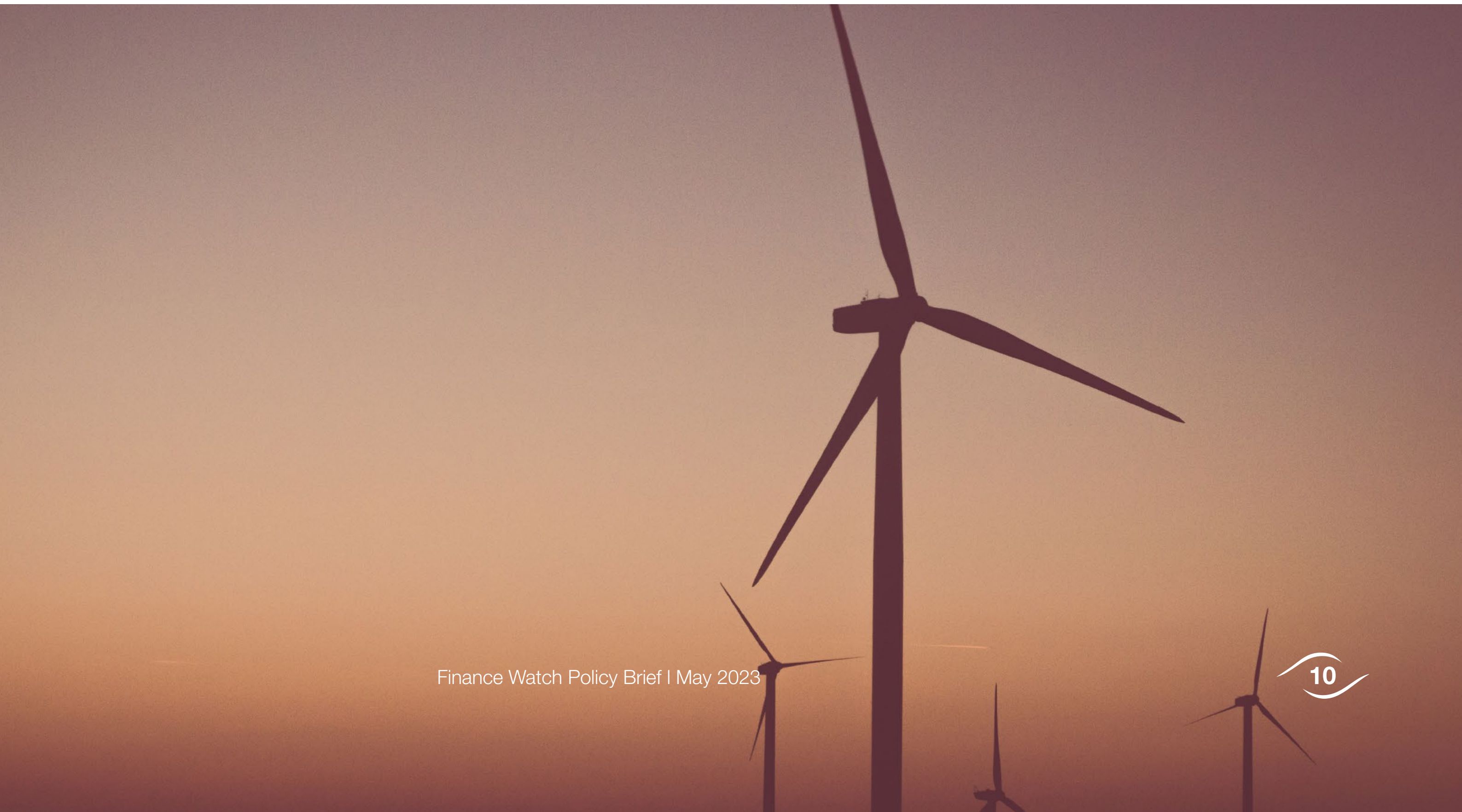
2 Network for Greening the Financial System, Capturing risk differentials from climate-related risks, May 2022.

3 European Central Bank, Walking the Talk, Banks gearing up to manage risks from climate change and environmental degradation, November 2022.

4 Article 2(17) SFDR provides a definition of 'sustainable investment' with an impact materiality logic, and this feeds Article 9 ("Where a financial product has sustainable investment as its objective") but many issues remain as SFDR does not equate 'sustainable investment' and 'ESG investing' and does not link the possibility of calling a fund 'sustainable' to impact materiality (hence the fact that most ESG funds are today Article 8 funds), this notwithstanding the many issues around the coherence of definitions with other pieces of regulation (Taxonomy, MiFID, CSDDD, IDD).

The debate around ESG investing is raging today with attacks coming from right and left. In some circles, ESG investing has become the scapegoat for all the evils of the world. At one extreme, the self-declared 'anti-woke capitalism' camp criticizes ESG investing for being disruptive of the usual (and in its view only effective) way of doing business whilst, at the other end of the spectrum, numerous voices accuse ESG investing of being intrinsically a greenwashing exercise as it brings nothing new to traditional investment management in its endeavor to capture the financial consequences of sustainability-related risks and opportunities. In other words, ESG investing is seen as detrimental to business as usual by one camp and guilty of being only business as usual by the opposite camp. In our view, none of those two contradictory accusations stands and ESG investing has to be taken for what it is, i.e. one of the tools at the disposal of society to incentivize the economic world to embark on a sustainability transition pathway, nothing more, nothing less. By the same token, ESG investing should not be taken as a miracle solution for all the planet's sustainability woes: there is only so much finance can do in the absence of adequate public policies. This does not mean that it is not a step in the right direction.

On top of the confusion created by the lack of a clear objective (financial materiality / impact materiality / double materiality debate), there is another structural problem with ESG investing and ESG rating, namely the aggregation of environmental (E), social (S) and governance (G) factors which, from a definitional standpoint, have little to do with one another. We argue in this policy brief that ESG rating providers should attribute to issuers different ratings depending on the dimension being rated (E, S or G) and the objective pursued (financial or impact materiality).



I. ESG rating in the context of ESG investing: what's in a name?

a. ESG performance: what is the objective of ESG investing?

ESG performance is a concept used more and more widely by ESG rating providers in the description they provide of the purpose of their work.

However, 'ESG performance' is one of those concepts that has the appearance of being obvious but is, in reality, nebulous as it can take a number of very different meanings. In our view, being able to assess ESG performance requires first to define what the objective of ESG investing is, and then to compare the outcome with the objective.

Possible objectives of ESG investing:

Three possible objectives can be sought by ESG investors:

- Limiting the risks and seizing the business opportunities linked to the world's sustainability (or lack of it). This is what sustainable finance specialists call outside-in financial materiality: it focuses, in a rather traditional way, on the link between sustainability and companies' accounts.
- Limiting the negative impact and maximizing the positive impact of enterprises' activities on their socio-environment. This is what sustainable finance specialists call inside-out impact materiality and, given its extra-financial dimension, it is where the novelty of ESG investing really lies.
- Taking into account both outside-in financial materiality and inside-out impact materiality to result in a comprehensive double materiality approach to the sustainability of economic activities.

The distinction between financial materiality and impact materiality and their combination in a double materiality approach has become a classic issue in ESG circles, and it is now reflected in EU regulation, in particular in the Corporate Sustainability Reporting Directive (CSRD). It is also expected to be an integral part of the European Sustainability Reporting Standards (ESRS) that will become European law in 2023 if the Delegated Act due to be proposed by the European Commission in the wake of the reports made by EFRAG in November 2022 is adopted. However, despite this regulatory recognition, double materiality is often nebulous in the practice of ESG investing. Ambiguity and confusion about the objective pursued by the ESG funds they manage seem to be the name of the game for many financial market participants.

We will come back to the three possible objectives of ESG investing when we relate ESG rating to precise objectives in section II.b.

b. Modus operandi of ESG investing and relation to ESG rating

Assessing the quality of assets is part of a normal investment process. This is true whether the objective of the investment is financial, sustainability-linked or a combination of both, as is the case for ESG investing.

Investors can analyse and assess the quality of the investments they contemplate either by conducting the research themselves or by acquiring it externally.

In the field of traditional (i.e. non ESG) equity investment, active asset managers typically purchase so-called ‘sell-side research’ from brokers or sometimes independent research bureaux and combine it, for the large ones, with their own ‘buy-side research’ to forge their opinion.

In the field of ESG investing, the bulk of asset managers, but not all, purchase so-called corporate ‘ESG ratings’ or ‘ESG scores’ from specialised providers. A feature of this market is that many large asset managers ask ESG rating providers to provide them with specific analysis tailored to their needs. The exception is asset managers acquiring sustainability data and conducting the ESG analysis they need to make investment decisions themselves (we have met several such asset managers).

There can be two reasons for investors to purchase corporate ESG ratings or analyses from a specialised provider.

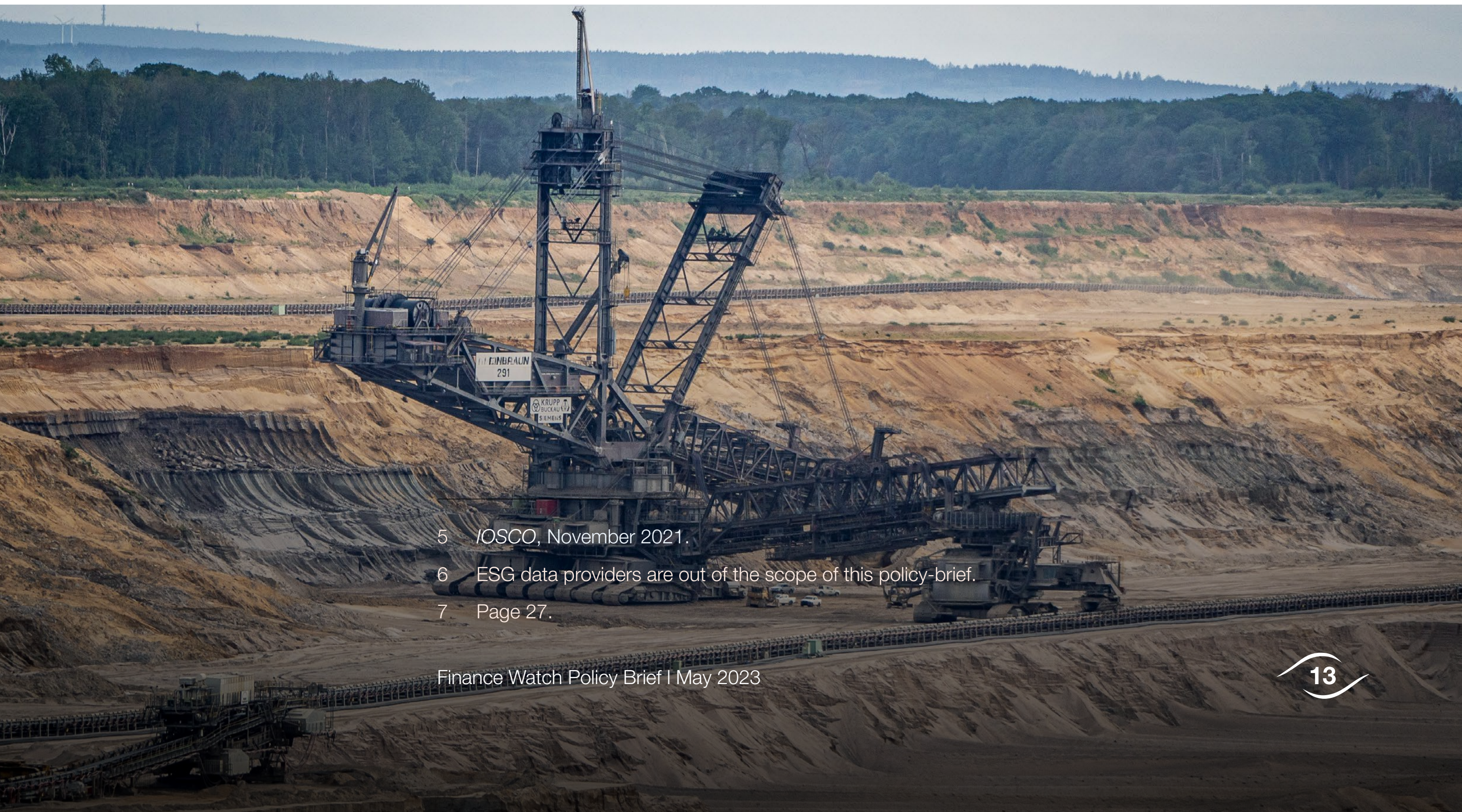
The first reason is to tick the box vis-à-vis regulators and substantiate ESG investing claims with a narrative along the lines of “you cannot accuse me of greenwashing as I invest following the ratings provided by a reputable ESG rating provider”. This is the ‘umbrella opening’ reason for purchasing corporate ESG ratings. Investors following that logic keep investing as they have always done by selecting investee companies on the basis of their financial merits (risk/reward profile) whilst adding on top a layer of ESG filter. Given the way the corporate ESG rating market is structured today, investment firms can cherry-pick the providers following the ESG rating methodology that best suits their investment style (growth, value, momentum…). In other words, they purchase the ESG ratings that allow them to continue investing more or less as they have always done with as little disruption as possible. ESG rating providers that consider only financial materiality have the best chances of attracting the interest of this (large) section of the asset management market. For obvious reasons, this way of proceeding has very little influence, if any, on the impact of investment portfolios on the sustainability of the world.

The second reason for investors to purchase ESG ratings from a specialised provider is to invest on the basis of the anticipated ESG performance of the rated assets. ESG performance has become one of the buzz words of ESG rating providers, it has the merit of catching the attention of a community of asset managers for whom ‘performance’ is the prime objective but, when applied to ESG, it is yet again an ill-defined concept that plays on ambiguity and rarely specifies whether it relates to financial or impact materiality.

This logic raises the issue of the predictive power of corporate ESG ratings and, as previously explained, this predictive power in turn depends on whether the ESG rating relates to the objective being targeted.

IOSCO's fact finding report on ESG Ratings and Data Products Providers[5] shows that a growing number of (mainly large and very large) asset managers tend to develop internally their own ESG ratings but rely on external ESG data providers to do so.[6] This, in our experience, does not represent the entire market though, as we are aware of a significant number of large asset managers who have entered into a contractual relationship with ESG rating providers whereby they receive ESG ratings tailor-made to their specific needs. In contrast, according to IOSCO, "producing proprietary internal ESG ratings may not be feasible or cost effective for small or medium sized asset managers".[7] The situation is also different for public users (public pension funds, central banks and government-owned financial institutions) which, according to IOSCO's report, rely exclusively on ESG ratings provided externally.

In any case, this varied usage landscape makes for the necessity to regulate ESG rating provision. Consistency of the ESG rating market is an essential block to build a coherent ESG investing practice.



5 *IOSCO*, November 2021.

6 ESG data providers are out of the scope of this policy-brief.

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II. Rationale for regulating corporate ESG rating

a. Five characteristics of corporate ESG rating

There is no such thing as a standard or a typical ESG rating, and this makes for a blurred landscape. Behind an ESG rating can lie a single or a double materiality approach, the aggregation using varying keys of very different ESG parameters, and an absolute or a relative assessment of companies' ESG merits. The one dimension that corporate ESG rating providers have in common is the limited human resources they devote to analysing the rated entities, which makes for an environment focused on the analysis of public documents, information and questionnaires, and where on-the-ground fact-finding, discussion with management and cross-checking has very little, if any, place. All this makes a comparison between ESG ratings coming from different providers at best very difficult.

1. Approaches to materiality

Many providers look only at financial materiality. A few providers look at financial and impact materiality together but they have different ways to combine them.

Many ESG rating providers (e.g. MSCI ESG Research, ISS ESG, Refinitiv, Sustainalytics…) assess ESG performance on the basis of financial materiality only. Their objective is to serve the community of investors who see the ESG angle of their investment practice as a way of limiting ESG-linked risks and seizing ESG-linked business opportunities. This approach is the most natural one for investors used to assessing the impact of external factors on companies' accounts. It is therefore not surprising that it should be dominant. This, as already discussed, contributes to the growing misunderstanding between professional investors and their retail customers as the notion of ESG investing does not have the same meaning for both categories, with the vast majority of retail investors seeing ESG investing as a way to contribute through the allocation of their savings to the sustainability of the world, not as a way of maximizing the financial risk/reward ratio of their investment. In other words, we are witnessing a situation where a very significant part of corporate ESG rating focuses on financial materiality when end-customers' interest is focused on impact materiality. However, some ESG rating providers (e.g. Moody's ESG or Ethifinance) claim to assess ESG performance on the basis of double materiality. The question, in those cases, is to determine to what extent and how the impact dimension of double materiality is taken into account and whether it corresponds to the expectations of end-investors. This last point leads, in turn, to the question of methodological transparency.

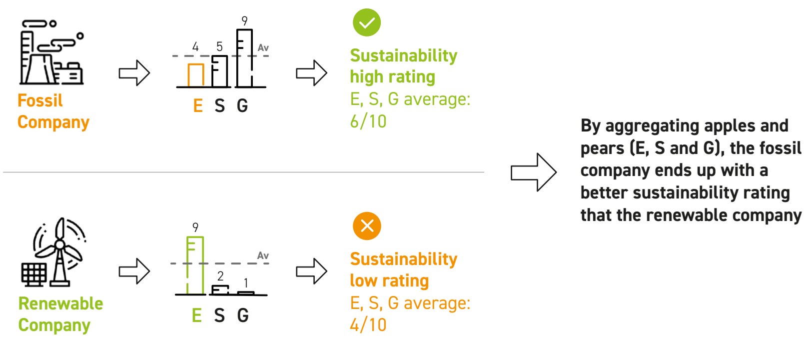
2. Aggregation of E, S and G factors

The aggregation of largely unrelated E, S and G factors into a single rating has a weak theoretical foundation and can disguise weaknesses.

Most corporate ESG rating providers derive their ratings by calculating a weighted average of unrelated environmental, social and governance parameters. This aggregation is particularly problematic as it gives a theoretically weak foundation to ESG rating. It can lead to awkward and unjustifiable situations where, for instance, an enterprise with a quality governance and good social policies but a disastrous environmental impact can end up having a high ESG rating and, subsequently, make its way into ESG investment portfolios. For an illustration, see Figure 1. Methodological coherence should be of the essence: orienting capital flows towards sustainable investments cannot be based on a single ESG rating metric bundling unrelated parameters with little logical, economic, theoretical or practical relationship.

Figure 1 - Aggregating apples and pears discredits sustainability ratings

Comparison between two fictitious enterprises



3. Weightings and methods for aggregation

Providers use different methods and weightings to aggregate E, S and G parameters into a single rating.

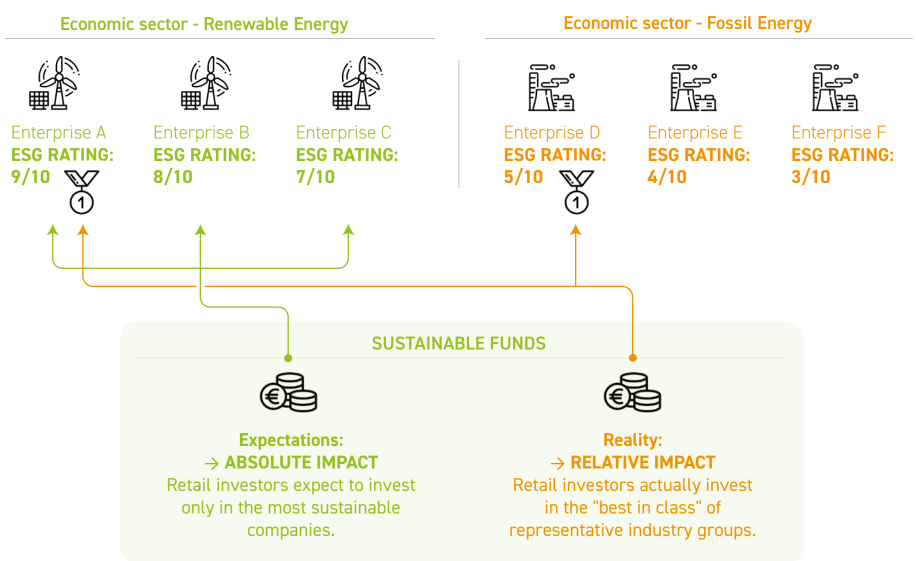
Notwithstanding the fact that corporate ESG ratings amalgamate otherwise unrelated E, S and G parameters (point 2 above), ESG rating providers do not have a consistent methodology for aggregating those parameters. Each provider seems to have its own recipe and uses different weights to aggregate into a single metric E, S and G parameters. This means that even in a hypothetical case where two such providers would use the same methodology to evaluate the underlying environmental or social risks, opportunities or impacts of a particular company, their synthetic metric would still be different.

4. Relative versus absolute assessments

Most providers focus on relative ESG performance, which for instance can allow polluting companies still to appear in ESG portfolios. Retail ESG investors and economic transition are better served by absolute ESG performance.

ESG rating providers' assessments of companies' ESG performance is most of the time not absolute but relative. For instance, MSCI describes its assessment of a company performance as "explicitly intended to be relative to the standards and performance of a company's industry peers".[8] A peer comparison may make some sense for an investor looking to build a portfolio with the best possible risk/reward profile (including the risks and rewards arising from sustainability issues), in other words for an investor looking only at financial materiality. In contrast, such a peer comparison is not relevant for an ESG investor considering impact materiality and is definitely not what retail investors are looking for when they invest in ESG funds. The disruption of the world that will inevitably derive from the unsustainable functioning of human societies and their economic system will not be influenced by relative values but by absolute impact: absolute GHG emissions feed global warming, absolute destruction of biodiversity will end up destroying nature and human societies with it, and actual human rights abuses make the lives of human beings not worthy of human dignity. The question of whether ESG investing, and therefore ESG rating, can be about allocating capital to companies and business who are, at the margin, less harmful than their peers should be considered in a context where the global economy, i.e. "the peers", is headed for an environmental and climate disaster and where the threat of social disruption is growing everywhere. It deserves our full attention if we want ESG rating to serve ESG investing and ESG investing to allocate capital to a sustainable economy or transitioning towards sustainability. In our view, inside-out impact has to be measured first and foremost in absolute terms, if anything because an exclusive industry (i.e. relative) approach creates biases and makes cross industry analysis difficult if not impossible. Rating the ESG credentials of a company relative to its industry peers only may result in situations where companies with a greater negative impact belonging to one industry group end up having a better ESG rating than companies with a better absolute impact in the next industry group (see Figure 2).

Figure 2 - The limits of the relative ESG rating approach



8 MSCI: *ESG Ratings Methodology*

This situation is highly undesirable. It is also impossible to understand for the layperson and is a recipe for creating general public distrust vis-à-vis ESG investing. However, a relative approach can also have its merits, provided it is conducted as a complement to an assessment in absolute terms. In the latter case, both assessments need to be conducted independently. It has to be noted though that some providers (e.g. ISS ESG) combine both a relative and an absolute approach to ESG rating. In any case, this point shows, if need be, the importance of methodological transparency in order to avoid confusion.

5. Limited human resources

ESG analysts have to cover a large number of companies, leaving little time to understand corporate strategies and creating a risk of gross misjudgments.

ESG rating providers' modus operandi relies, to a large extent, on public data and documents as well as on the questionnaires sent to the companies being rated. Contrary to what happens in the world of equity research, the world of ESG rating is unfamiliar with hard fact-finding, on-site visits or discussions with the management of the firms analysed. This situation is the result of the providers' business model and of a policy of minimizing costs in order to maximize margins. This has the consequence of making ESG rating providers prone to gross misjudgments, as evidenced by the Orpea scandal that burst in France in 2022.[9] With the current ESG investing trend going global, the large ESG rating providers have the ambition of covering eventually all the stocks listed in the world. For instance, Refinitiv follows about 8,000 companies, MSCI more than 10,000[10] and ISS 7,000 companies corresponding to 12,500 issuers.[11] Comparing the number of companies followed by ESG rating providers with the number of analysts following them is telling: in its brochure dated 24 March 2022, MSCI explains for instance that *"MSCI ESG Research LLC consists of approximately 84 employees, including approximately 29 ESG analysts and researchers"* and that *"Through its foreign affiliates, MSCI ESG Research leverages a total of approximately 600 ESG employees including approximately 250 analysts and researchers"*, whilst ISS ESG has said it employs 270 ESG analysts. If these numbers reflect without doubt a commitment to doing professional work on those providers' part, one must bear in mind that, in the world of equity research, a sell-side analyst follows about 10 listed companies only, with a small margin of variation depending on the complexity of the companies followed. This means that, in order to conduct professional equity research

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9 Orpea, a large listed group in the business of running nursing homes for the elderly, had received an excellent ESG rating from most providers when a book (Les Fossoyeurs) by investigative journalist Victor Castanet came out in January 2022 denouncing, among others, Orpea's ill-treatment of elderly people.

10 MSCI: *ESG Research LLC*

11 ISS: *ESG RATINGS & RANKINGS*

on the same number of companies, MSCI would need to employ 1,000 analysts, and ISS ESG 1,250, i.e. about five times as many as they employ ESG analysts. Moody's ESG has a different approach and goes far beyond the world of listed companies: it claims to deliver ESG model scores for 300 million companies in the world (!) [12] and to employ 5,000 analysts to conduct ESG scores with analytical overlay. In any case, these numbers speak for themselves and reveal for ESG research a business model, and an ability to conduct the research, entirely different from equity research. The number of analysts employed by corporate ESG rating providers may sound high but it is definitely too low to allow for those analysts to conduct on-site visits, talk with the management of the companies followed, understand and assess the quality of the firms' strategy and of their management, and cross-check facts. This is true for all ESG rating providers and is all the more important for rating providers assessing the impact of rated entities on their socio-environment: assessing inside-out impact and its future evolution entails understanding the strategy of the rated entity and it is a highly human resources intensive process. There is a case for thinking that the relatively low level of human resources of ESG rating providers linked to their business model gives them a limited ability to assess properly the impact of companies on the environment and on society, in particular in a forward-looking perspective. This raises questions about the predictive power that ESG ratings are meant to have.

Considering these characteristics, it should be no surprise that several pieces of academic research have pointed out the low correlation between ESG ratings.[13] Different ESG ratings effectively measure different dimensions and, in that context, there is no reason why they should be correlated. As a matter of fact, it would be a miracle if ESG ratings emanating from different ESG rating providers were correlated given that they do not measure the same thing and they use different methodologies.

Both credit analysis and equity research are rigorous processes but equity research leaves more room for opinion than credit analysis, hence the fact that the credit ratings provided by the different credit rating agencies are highly correlated, whereas the opinion of different equity research teams of otherwise undisputed quality can diverge significantly. Hence also the fact that equity analysts forge a reputation for themselves as professionals (a reflection of the fact that not all equity research analysts provide research and investment recommendations of the same quality) and the identity of the equity analysts writing research reports often counts more than the firm employing them. In contrast, in the credit rating world the agency counts more than its analysts, regardless of the quality of those analysts. Equity research bureaux seek to attract the star analysts as this adds value to their franchise, while credit rating agencies sell their brand regardless of the individuals they employ as analysts. In that respect, ESG rating providers are more comparable to credit rating agencies.

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12 *ESG at Moody's*

13 e.g. The Review of Finance, "Aggregate Confusion: The Divergence of ESG Ratings", Florian Berg, Julian Kölbel and Roberto Rigobon, November 2022.

b. Relating ESG rating to its objectives

The question is often asked of whether ESG rating is more akin to credit rating or to equity research.

In a first approach, the financial materiality dimension of ESG rating can be compared to credit rating with its outside-in logic and its objective of assessing the impact of external (ESG) factors on companies' financials, just as credit rating is about assessing the impact of the different possible states of the world on the rated companies' ability to pay back their debt. Conversely with its inside-out logic, impact materiality analysis can be, to some extent, compared to equity research: given that very few businesses operate today in a sustainable manner, the key question to determine is whether management teams are able to take the companies they lead on a transition pathway with a positive impact on the world's sustainability. Put differently, financial materiality analysis can, like credit assessment, be considered as more quantitative while impact materiality analysis can, like equity research, be considered as more qualitative, even if qualitative analysis leads also to quantifiable consequences such as the impact on enterprise value. One thing ESG impact analysis and equity research have in common is that they require an extensive understanding of the analysed companies' strategies. This, in turn, raises the question of the human resources devoted to conducting this analysis (as described above, the human resources devoted to ESG analysis by ESG rating providers are a fraction of the human resources that sell-side research bureaux devote to equity research).

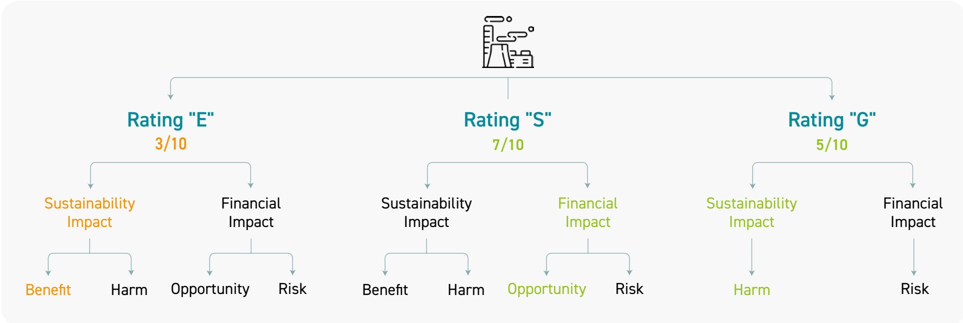
However, a closer look can make us see that ESG rating as such is comparable with neither credit rating nor equity research.

The main difference between credit rating and equity research on one hand and ESG rating on the other hand is that credit rating and equity research measure one factor only. Credit rating assesses the ability of an issuer to repay its debt, and it encapsulates this assessment in the probability of default that it attributes to the issuer. Equity research assesses the value of a company given its strategy, its market and its management and it converts this assessment into a 'buy/hold/sell' recommendation for investors. ESG rating, in contrast, is a multi-factor exercise with multiple different dimensions (see Figure 3).[14]

14 The following difference between environmental and social parameters on one hand and governance parameters on the other hand is often overlooked: governance, contrary to a preserved environment or to a well-functioning society, is not an objective as such but a pre-requisite. G is of a different nature from E and S: governance is a condition of proper management and adequate corporate behavior, as opposed to E and S which are the results of companies' action.

Figure 3 - How can we agree on ratings if we don't measure the same thing?

Detail of the ESG rating of a fictitious enterprise



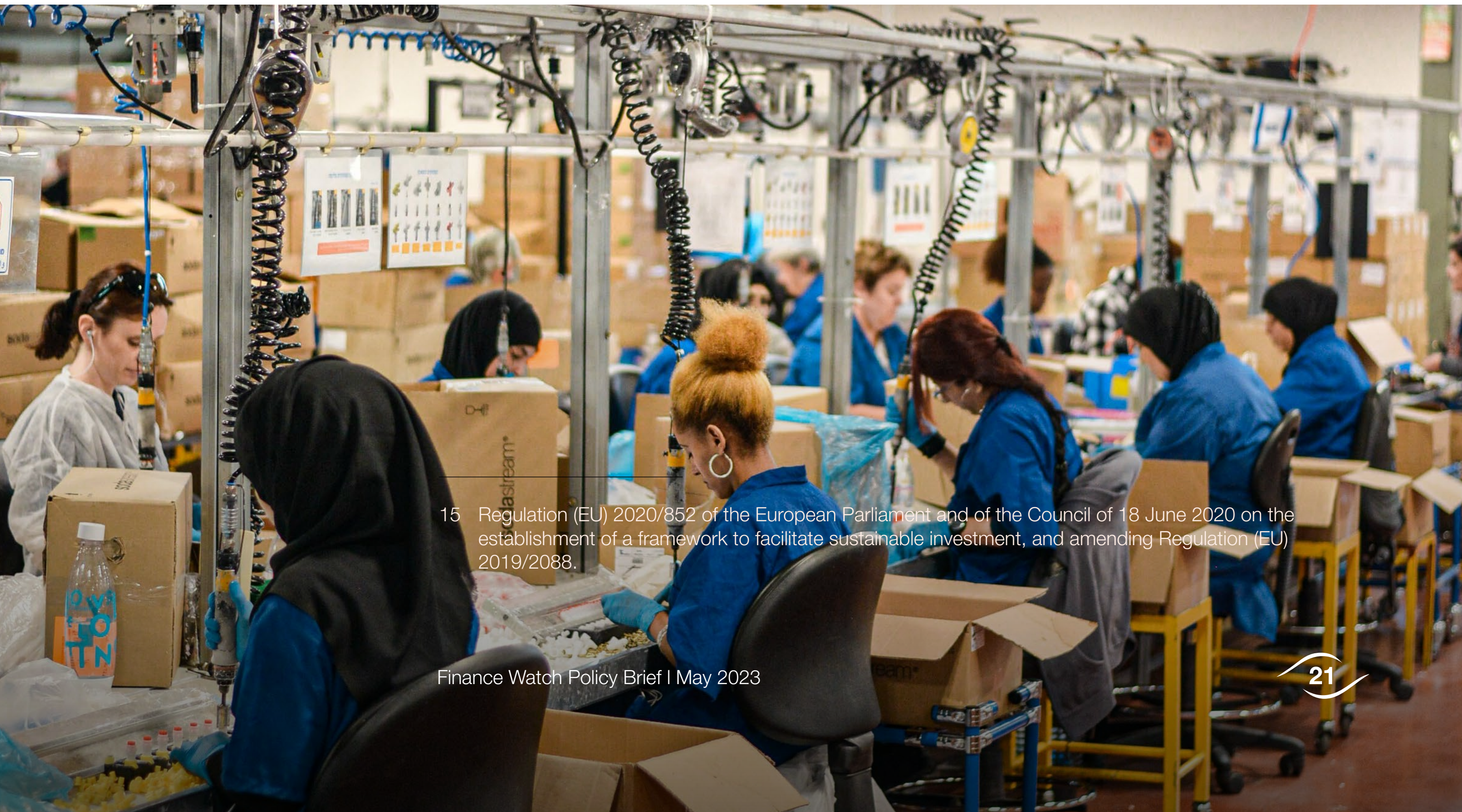
A point is sometimes made that the financial materiality dimension of ESG analysis is effectively traditional financial analysis. After all, financial analysis takes into account the risks and opportunities encountered by the companies analysed regardless of their source, doesn't it? This point is conceptually correct but ignores the question of the time horizon considered. Some ESG risks and opportunities, despite being evident, are not captured by financial accounting and, as a consequence, by financial analysis. Take the example of fossil fuel stranded assets. At the time of writing this report (2023) holding fossil fuel reserves is the clever thing to do if you only consider financial accounting and analysis (oil and gas companies are reporting all time-high profits). However, if you consider sustainability reporting and analysis, you realise that, due to climate change, the value of fossil fuel reserves is doomed under all possible scenarios. Only sustainability analysis can capture this phenomenon. When it comes to analysing the financial consequences of holding fossil fuel reserves in 2023 (we are only considering the financial consequences here, not the environmental impact), financial analysis and sustainability analysis with a financial materiality angle send us radically different messages: financial analysis is as positive as could be, whilst sustainability analysis is as negative as could be. This is due to the difference in time horizons. The financial materiality dimension of ESG analysis is of a different nature from financial analysis as it considers, or should consider, medium and long term sustainability-related financial impacts not taken into account by financial accounting, and therefore financial analysis, today.

In summary, in order to be meaningful and therefore useful, corporate ESG ratings should distinguish between the eight possible following dimensions:

1. Issuer's financial risk caused by environmental factors.
2. Issuer's financial risk caused by social factors.
3. Issuer's financial opportunities linked to environmental factors.
4. Issuer's financial opportunities linked to social factors.
5. Issuer's impact on the environment.
6. Issuer's impact on society and people.
7. Issuer's governance quality from a financial materiality standpoint.
8. Issuer's governance quality from an impact materiality standpoint.

Distinguishing between those eight different dimensions would not only avoid the trap of expressing ESG ratings as a single metric effectively void of sense, but it would also have the virtue of ensuring the coherence of the sustainability assessments produced with a sufficient level of granularity.

With the EU Taxonomy regulation[15] now in force, the necessity of such a granular approach is particularly strong to assess companies' impacts on the environment. The Taxonomy regulation and its ensuing Delegated Acts classify economic activities for their sustainability characteristics and attribute thresholds to them to determine the level from which they contribute substantially to an environmental objective and the level from which they harm substantially other objectives. In this context, attributing a rating to a company for its impact on the environment without linking to the alignment of its activities with the EU environmental Taxonomy would be incoherent and would only add confusion, where there is an urgent need for clarity and ease of understanding. We can easily imagine situations where, in the absence of such a link, a company with a low Taxonomy alignment would receive a good rating for its environmental impact. This would be highly undesirable.



15 Regulation (EU) 2020/852 of the European Parliament and of the Council of 18 June 2020 on the establishment of a framework to facilitate sustainable investment, and amending Regulation (EU) 2019/2088.

III. Recommendations for a regulation of corporate ESG rating

a. Three principles that corporate ESG rating should respect

Whether developed internally or acquired externally, ESG rating should, like credit rating and equity research, be based on three principles:

(i) it should have a clear objective, be transparent about the methodology it uses and be coherent with EU regulation (in particular the Taxonomy regulation);

(ii) it should be founded on reliable and identified data;

(iii) it should be unbiased and free of conflicts of interests.

When those three principles are respected, the conditions for a fair analysis and subsequent rating exist. This is true regardless of whether we are considering financial analysis or sustainability analysis. If one of those principles is not respected, let alone several, then scores, recommendations and ratings will become misleading and can in many cases be assimilated to manipulation or, in the case of ESG rating, to greenwashing. Regulation is indispensable to avoid such a situation.

b. Recommendations

Scope of supervision: who needs to be supervised and who should supervise?

The provision of ESG ratings in the EU and their use by EU investors should be supervised by ESMA:

- In order to provide corporate ESG ratings to EU-based clients, ESG rating providers should have a permanent establishment in the EU and should be subject to authorisation and supervision by ESMA.
- The authorisation of ESG rating providers should be based on the provision by the entity seeking authorisation to ESMA of its business plan, its description of the governance structure, its resourcing arrangements, policies and procedures to prevent conflicts of interest, and the detailed description of its methodologies.
- EU-based users of ESG rating services and investment firms selling services to EU clients should have the obligation to only purchase ESG rating services from ESMA-authorised ESG rating providers.
- ESMA should have the power to control and, as the case may be, impose sanctions for non-compliance on the ESG rating providers it supervises.

What needs to be regulated?

- **Separate and specific objectives**

  Expressing ESG ratings in the form of a single metric aggregating E, S and G both in their financial materiality and their impact materiality dimensions is nonsensical. The provision of an ESG rating in the form of a single metric should be forbidden as misleading.

- ➔ ESG ratings should be separated into standalone E, S and G assessments and renamed sustainability ratings.
- ➔ In each case, the rating provider should state if they are assessing financial materiality or impact materiality. The standalone sustainability ratings should be provided mandatorily along the following distinction:
  - » financial risk caused by environmental factors.
  - » financial risk caused by social factors.
  - » financial opportunities linked to environmental factors.
  - » financial opportunities linked to social factors.
  - » impact on the environment.
  - » impact on society and people.
  - » governance quality from a financial materiality standpoint.
  - » governance quality from an impact materiality standpoint.
- ➔ Providing a rating on some but not all possible dimensions should be authorised.

- **Taxonomy alignment**

  The attribution of ratings related to the impact on the environment should be linked to the EU Taxonomy regulation and possible discrepancies explicitly justified (e.g. a high rating despite a low Taxonomy alignment).

- **Transparency**

  Transparency should apply to the methodology used and to the data sourcing of the ESG ratings attributed.

  - ➔ Methodology:
    - » A description of the methodology used by the ESG rating provider should be submitted to ESMA for approval before it starts to operate.
    - » Methodology should be made publicly available by ESG rating providers. Full transparency should be the rule on whether the ratings assess an absolute performance or a performance relative to peers.
  - ➔ Data sourcing:
    - » A description of the data sources actually used by rating providers should be made available to users.

      (As an illustration, ESG rating providers have the following sources of information at their disposal: public reports, public information provided by the rated entity, CSRD-related information provided by the rated entity, response to ad-hoc questionnaires sent by the ESG rating agency, third party data suppliers, NGO reports, social media and publicly available on-line information, controversies, media, private exchanges between rating agency and rated entity, on-site visits, other...)

» ESG rating providers should make explicit whether, or not, the data used has been subject to external independent assurance or audit.

- **Conflicts of interest**

  ESG rating providers should be prohibited from selling consultancy services to companies they are rating, have internal controls and procedures to manage conflicts of interest, should not rate their own shareholders, and no entity should exercise control over more than one ESG rating provider.

  → (similar to CRA Regulation): ESG rating providers should establish, maintain, enforce and document an effective internal control structure governing the implementation of policies and procedures for the prevention and control of possible conflicts of interest and for ensuring the independence of ESG ratings, rating analysts and rating teams regarding shareholders, administrative and management bodies and sales and marketing activities. Operating procedures should be put in place relating to corporate governance, organisational matters, and the management of conflicts of interest. Operating procedures should be periodically reviewed and monitored to evaluate their effectiveness and whether they should be updated.

  → ESG rating providers operate on an "investor pays" business model. However, a number of ESG rating providers both sell ESG ratings and / or scores to investors and ESG analysis or consulting services to issuers. This creates a conflict of interests when the companies buying the consulting services are rated by the rating provider. Institutions selling ESG ratings to investors should therefore be prohibited from selling any form of services (advisory, consulting, etc…) to the issuers on which they provide ESG ratings or scores.

  → ESG rating providers should be prohibited from providing ESG ratings or scores on companies holding their equity or providing them any form of capital, including debt.

  → Conversely, entities purchasing or professionally using ESG ratings or scores (whether financial or non-financial companies), should not be allowed to be shareholders of the ESG rating providers whose ratings they buy or use, nor provide to them any form of funding, credit facility or capital.

  → (similar to CRA Regulation): The perception of independence of ESG rating providers would be particularly affected should the same shareholders or members be investing in different credit rating agencies not belonging to the same group of credit rating agencies, at least if such investment reaches a certain size that could allow those shareholders or members to exercise a certain influence on the ESG rating agency's business. Therefore, in order to ensure the independence (and the perception of independence) of ESG rating providers, it would be appropriate to provide for strict rules regarding the relations between the ESG rating providers and their shareholders or members. For that reason, no legal or natural person should simultaneously hold a participation of 5 % or more in more than one ESG rating provider, unless the ESG rating provider concerned belongs to the same group.

In that respect, the following provisions (inspired by the CRA regulation) would be welcome:

» A shareholder or a member of an ESG rating provider holding at least 5 % of either the capital or the voting rights in that ESG rating provider or in a company which has the power to exercise control or a dominant influence over that ESG rating provider, shall be prohibited from: (a) holding 5 % or more of the capital of any other ESG rating agency; (b) having the right or the power to exercise 5 % or more of the voting rights in any other ESG rating provider; (c) having the right or the power to appoint or remove members of the administrative or supervisory board of any other ESG rating provider; (d) being a member of the administrative or supervisory board of any other ESG rating provider; (e) exercising or having the power to exercise control or a dominant influence over any other ESG rating provider.

Conclusion

Discussions around ESG investing have attracted increasing scepticism and emotion in recent months. For every critic who wants investment to be about financial returns and nothing more, there is another who wants it to change the world.

Only some of this tension can be explained by politics. A good portion of the blame lies with the processes developed by the ESG investment community itself.

As the ESG ratings industry has developed, it seems to have missed the step where it asks what individual ESG investors need and has instead developed a wide range of differentiated products with broad but superficial appeal.

The result is a messy landscape littered with jargon, inconsistent definitions, complex methodologies and mysterious numbers that can be neither understood nor compared.

Underneath this is an ambitious but under-resourced industry, with a ratio of ESG analysts to companies that is only a fifth of that in the equity research industry, attempting to monitor one of the largest shifts in economic history.

The appetite and the need for sustainable investment is high but if customers cannot understand why a company has a high ESG rating, they must take it on faith. That means the market cannot correct itself until the inevitable greenwashing scandals emerge and damage public trust in the whole industry.

The recommendations in this paper aim to make this less likely by making it easier for ESG investors to find the sustainability information that they are interested in, regardless of whether they are aiming for a financial return or a sustainable world.

Annex – The use of ESG ratings in financial products

The issues raised in this briefing paper are equally relevant for users of corporate ESG ratings, especially providers of composite financial products and instruments.

Asset managers buy corporate ESG ratings to create ESG financial products and instruments, such as mutual funds (UCITS)[16] or alternative investment funds. The process of assessing the level of sustainability of the resulting financial product can involve aggregating the corporate ESG ratings of the underlying securities. This is hugely complicated by the variations and methodological differences between corporate ESG ratings described above, especially in relation to absolute versus relative assessments and the production of composite ratings.

The level of sustainability of the financial product is also needed to help comply with rules on financial advice, for example when salespeople have to ensure that a product meets the sustainability preferences of retail end-investors. This brings into play a further set of regulations (MiFID, IDD, SFDR), some of which use different definitions for investment funds.[17]

At present, asset managers can take non-comparable ESG ratings, combine them with other sources of information using their own proprietary methodology, and present a single metric, expressed as a percentage, to show how the financial product aligns with an end-investor's sustainable investment preferences. This will be impossible to fathom for the vast majority of retail customers of ESG funds.

This cascade of uses and regulatory interactions makes it important to have a coherent framework for corporate ESG ratings as the first step in the chain, and to consider how the framework can be applied to others in the value chain to bring value to end-investors.

A full analysis is beyond the scope of this briefing paper but we suggest as a first thought that the "separate and specify" approach (the second recommendation in this briefing paper) could also be applied to manufacturers of ESG financial products and instruments, so that the sustainability ratings for their products and instruments would be based on the standalone sustainability ratings of the underlying assets, separated for each type of materiality, rather than on composite ratings.

16 UCITS: Undertakings for Collective Investment in Transferable Securities (EU regulated investment funds).

17 MiFID: Market in Financial Instruments Directive; IDD: Insurance Distribution Directive; SFDR: Sustainable Finance Disclosures Regulation. In an unwelcome lack of coherence of definitions in EU financial regulation, investment funds are defined as "financial products" under SFDR and under the Taxonomy regulation and as "financial instruments" under MiFID and IDD.

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Finance Watch is an independently funded public interest association dedicated to making finance work for the good of society. Its mission is to strengthen the voice of society in the reform of financial regulation by conducting advocacy and presenting public interest arguments to lawmakers and the public. Finance Watch's members include consumer groups, housing associations, trade unions, NGOs, financial experts, academics and other civil society groups that collectively represent a large number of European citizens. Finance Watch's founding principles state that finance is essential for society in bringing capital to productive use in a transparent and sustainable manner, but that the legitimate pursuit of private interests by the financial industry should not be conducted to the detriment of society. For further information, see www.finance-watch.org

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