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ESG Ratings – Between Scylla and Charybdis

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What is a rating?

Noun

Rating (plural ratings) /ˈɹeɪtɪŋ/

1. A position on a scale
2. An evaluation of status, especially of financial status
3. A number letter, or mark that refers to the ability of something
4. A seaman in a warship
5. The status of a seaman on a warship, corresponding to rank in officers

Where does ESG ratings sit relative to credit ratings?

A Credit rating is an opinion on the likelihood of timely payment of debt relative to contractual agreements.

While it is an opinion, it is based on quantitative analysis with at best some known cause effect relationships, and qualitative analysis based on experience and expectation.

The statistical performance of ratings (migration from one level to another or indeed a default) then indicate that a given rating carry a statistically relevant average likelihood of default for a given time period.

This is supported by an operational history of more than150 years.

Rating = probability of default

An ESG rating does not have a commonly agreed upon definition similar to credit ratings

It combines factors, the impact of which, vary considerably for companies over time and in time but do not necessarily drive a common direction.

While conceptual ambitions may be very clear at a theoretical level the industry struggle with operationalisation.

Yet the represent arenas of rapidly growing importance for capital market participants not the least due to the rising importance of norm-critical academic theory and discourse.

This is in part dependent on an operating history which is closer to 20 years than to 150.

ESG – A brief history

The Second World War was fought, in part, on a moral imperative – Human Rights

The Post-war period institutionalized a Human Rights as a concept and entailed the creation of the welfare state. It also saw the creation of institutions for a legal world order (UN, IMF, WB, OECD, EU, NATO, etc.)

1950s - De-colonisation

1962 *Silent Spring* - Rachel Carson

1960s onwards - The fight against Apartheid – a driver for corporate responsibility

Nuclear resistance and growing environmental awareness in the 1970s.

1970s and 1980s - Environmental regulation

1980s Financial deregulation – Friedman – Shareholder value

1989 the Nordic Swan label; System Science – The Natural Step

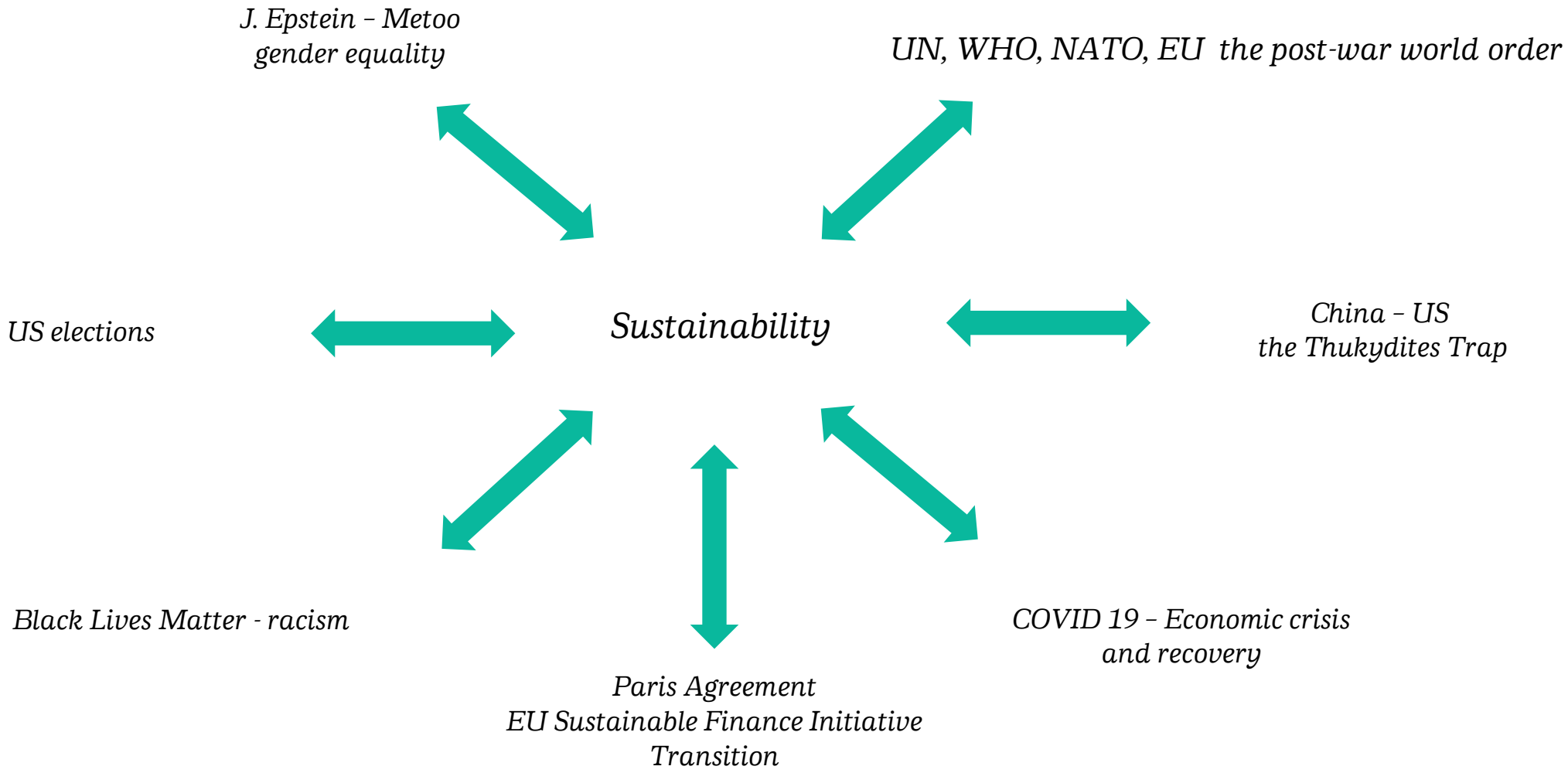
1998 *Cannibals with Forks: the Triple Bottom Line of 21st Century Business* – John Elkington

2000 Corporate Social Responsibility

2008 ESG is the term best suited to reference

2020 Sustainability is replacing ESG – EU Sustainable Finance Initiative – The EU Taxonomy – 2nd Non-Financial Disclosure Directive

Short to Medium term - Sustainability is the battle field for the future



Why Scylla and Charybdis?

Scylla – The risk of only pretending

ESG ratings can easily be turned into what is commonly known as 'greenwashing' – a pretence to claim that something is done, which really is not

www.boohoo.com a recent example
https://www.ftadviser.com/investments/2020/08/07/boohoo-issues-highlight-esg-minefield-for-advisers/

This may be the result of both the appraiser's and the rated entity's actions

Charybdis – The actual risks

ESG analysis is highly relevant due to risks that companies, investors, societies and even individuals face.

Risks may be ecological (Talvivaara Mining – bio heap leaching of nickel) and lead to material financial losses for investors, and cost to society.

Risks may be on governance (Danske Bank, LGT Bank, Arthur Andersen, Parmalat, Enron, Skandia, Hafnia ...) and lead to financial losses for investors, staff, and society.

Risks may be socially related (Hugo Boss, IG Farben, Finnair) and lead to value destruction and competitive disadvantages

Risk may impact all factors – climate change – and will have far reaching implications for any business

The ESG market – a complex soup with many ingredients

MSCI

ISS ESG

Trucost ESG Analysis

S&P Global

ROBECOSAM

We are Sustainability Investing.

vigeoeiris

MEMBER OF

Dow Jones Sustainability Indices

In Collaboration with RobecoSAM

SUSTAINALYTICS

imug | rating

FTSE Russell

CDP

There are literally hundreds of agencies …

What are ESG ratings trying to capture?

1. Doing good – showing support for good causes
2. Being responsible – having policies
3. Measuring impact – Scope 1, 2 and 3 etc.
4. Transparency – primarily relying on public information

E – Environment

Investments
Emissions
Sustainable products

S – Social

Diversity
Human Rights
Consumer protection
Data security & cyber crime

G- Governance

Management structure
Executive compensation
Compliance
Regulation
Employee relations

Used to:

1. Screen investment opportunities
2. Secure mandate compliance
3. Measure impact of investments

How do the agencies define their ratings?

ESG may be obviously important topics to discuss, but defining the aim is not so easy.

Sustainalytics ESG Risk Rating measures the degree to which a company's economic value is at risk driven by ESG factors OR, more technically speaking, the magnitude of a company's unmanaged ESG risks.

MSCI ESG Ratings are designed to help investors to understand ESG risks and opportunities and integrate these factors into their portfolio construction and management process.

Vigeo Eiris analyse the extent to which companies can secure and enhance their value creation over the mid and long term through their willingness and capacity to integrate sustainability criteria into their strategy, risk management and operations.

Key building blocks overlap - but do they mean the same?

MSCI ESG Rating

- Financing Environmental Impact
- Human Capital Development
- Access to Finance
- Privacy and Data Security
- Financial Product Safety
- Financial System Instability
- Corporate Governance

Vigeo Eiris

- Environment
  - Environmental strategy
  - Development of green products…
  - Minimising environmental impact from climate change
  - Management of environmental impacts from transportation
- Human resources
  - Promotion of labour relations
  - Resp. management of restructurings
  - Career management and promotion …
  - Improvement of health and safety
- Human rights
  - Respect for human rights …
  - Respect for freedom of association …
  - Non-discrimination and diversity
- Community involvement
  - Promotion of social and economic development
  - Social impacts of products/services
- Business behaviour (C&S)
  - Info to customers
  - Responsible customer relations
  - Prevention of corruption and ML
  - Transparency and integrity of lobbying
- Corporate governance
  - Board of directors
  - Audit and internal controls
  - Shareholders

Sustainalytics

- Human Capital
  - Freedom of association policy
  - Discrimination policy
  - Diversity programmes
  - Employee turnover rate
  - Labour relations
- Business Ethics
  - Bribery and corruption policy
  - Whistleblower programs
  - Money laundering policy
  - Involvement policy
  - Accounting and taxation
  - Lobbying and public policy
  - Sanctions
  - Anti-competitive practises
  - Bribery and corruption
  - Business ethics
- ESG Integration – Financial
  - Responsible asset management
  - PRI signatory
  - Responsible investment policy
  - Responsible investment program
  - Financial inclusion
  - Environmental impact of products
  - Social impact of products
  - Society human rights

ISS ESG

- Environmental Rating
  - Environmental management
  - Products and services
  - Eco-efficiency
- Social and Governance Rating
  - Staff and suppliers'
  - Society and product responsibility
  - Corporate governance and business ethics

What are the problems?

Communication has been a weakness, with information on rating actions not being shared with the rated entities even though rating actions may result in investors having to sell their holdings.

ESG methodologies are neither systematic, transparent, valid nor reliable. This reflects the lack of a common understanding of what is being measured. ESG agencies have had a tendency to keep their methodologies secret as they claim that publishing them would expose their unique value creation.

ESG rating agencies commonly reference 'indicators' as the means by which they operationalise their analyses. Such indicators may be the number of wheel chair ramps, the existence of a specific policy document, or a news article, or a third party report. Such indicators are weighted together in complex models, which have little documented validity but express a high degree of precision.

The tendency is to measure what is possible to get, rather than what is the valid operationalisation of sustainability. One reason for this is that companies are not producing relevant data in a systematic fashion.

ESG analyses tend to be company specific and analytical staff is often located in locations such as India and the Philippines due to labour cost restrictions. This in turn means that ESG rating agencies neither have local language skills nor the necessary understanding of the interplay between laws, regulations and company policies in any particular country.

Because of the existing weaknesses described, the indicators are backward looking focusing on policy and procedure rather and efficiency, risk and future performance.

Are ESG-ratings becoming more comparable?

Since ESG-ratings have evolved from a narrow focus on environmental factors to a gradually broader scope, but without a common reference framework, the level of comparability between ratings is low.

At the same time ratings are unsolicited, which implies that any company may have to manage very conflicting analyses. Or indeed is unaware of ratings.

Sustainalytics provide an issuer pays service, where they are willing to consider more information outside the public domain.

Vigeo Eiris has signalled that they will be moving to an issuer-pays model in the near future. This in turn will force them to become more transparent about their analytical framework. The integration with Moody's will also imply that they cannot continue to deviate from Moody's Customer Charter the way they currently do.

The fact that Moody's have made this move is likely to trigger similar moves by S&P and Morningstar and will put pressure on Fitch to up their game. More consolidation will likely result.

The incumbent specialists will come under increasing pressure to open their methodologies to public scrutiny and become more professional in their analysis. MSCI ESG Ratings, which prides itself of its near complete non-dialogue policy, will come under pressure when Vigeo Eiris and Sustainalytics develop more transparent and dialogue-based business models.

ESG Ratings – fast forward

ESG Ratings + credit ratings = True

2018 seems a long time ago in the ESG ratings world. Two years ago ESG ratings were still seen as a novelty, and a dicipline separate from credit ratings.

In the course of 2019 ESG-ratings have become more commonly referenced and the rapid growth in investor focus has caught the attention of credit rating agencies:

S&P Global acquired a controlling stake Trucost already in 2016. However, Trucost is a small player in the ESG-rating space and has not been featured strongly in S&P communication until 2019, when it has become a more integrated part of the S&P Global offering. In 2019 S&P also acquired Robeco SAM a major ESG data provider.

Morningstar, the fund rating agency, acquired 40% of one of the leading player, Sustainalytics, in July 2017. This was the followed by the acquisition of the credit rating agency DBRS in July 2019 and a full acquisition of Sustainalytics in 2020.

Moody's acquired a majority stake in Vigeo-Eiris, the leading French ESG-agency, in April 2019. It also acquired a minority stake in Chinese, Syn Tao Green Finance in October 2019.

Moody's was the first of the major credit rating agencies to include ESG analysis in its credit rating in 2018.

The credit rating agency Fitch launched its own ESG assessment as an integrated part of its credit ratings in 2019.

A similar initiative was launched by S&P in 2019, Scope Ratings and Nordic Credit Rating in 2020.

Is the specialized ESG rating an endangered spices?

ESG ratings are still provided by a large number of specialist agencies, however the consolidation is set to continue.

The credit rating agencies experience in managing relationships, regulation, capital market legislation as well as their broader market presence will given them a material advantage compared to specialised ESG-agencies.

Three key themes are deciding the future of specialized ESG-agencies:

Validity

What does an ESG-rating capture?

Reliability

Are ESG-ratings comparable?

Transparency

Can the ratings be understood and interpreted?

Can the ratings be understood and interpreted?

Today it may be argued that you may chose the conclusion that fits your agenda since there is such a low level of transparency around the many rating models that exist and concepts are so vaguely defined.

This also means that it is difficult to make decisions based on ESG ratings.

For ESG-ratings to move from being difficult to control risks to becoming relevant tools for decision making, a greater degree of harmonisation is required.

The process for establishing a better basis for ESG assessments requires that analysis is systematic, comprehensive and transparent. A 360 degree review of a business requires analysis of the organisation itself, its regulatory and legal operating conditions across markets and geographies as well as the societal norms, conditions, and requirements that are put on any one organisation wherever it operates.

What is the big agenda

The Credit Rating Network comprising the 22 leading banks in Europe is currently focusing on ESG-ratings and their increasing role of importance to investors in the capital markets. In 2019 a survey amongst the member banks show dissatisfaction with the status quo and a desire that ESG rating agencies being operating more along the practises of credit rating agencies i.e:

- That there is a regular dialogue with rated entities;
- That there is a comprehensive review process for all ratings;
- That communication of ratings and their changes is public transparent and complete;
- That criteria and methodologies are reliable valid and transparent; and
- That changes in criteria or methodologies are open to comments from all market participants.

Regulation is on the horizon

- In 2018 EU launched its 'Sustainable Finance Initiative', which identifies the capital markets as the catalyst for the necessary transition to a sustainable society.
- The Taxonomy on sustainable activities (E) presented in 2019 outlines precisely what business activities fall into the sustainable fold.
- Supporting the transition is also an increased requirement to report on non-financial risks.
- Finally a series on current surveys and investigations conducted on behalf of the EU are focusing on the quality and functioning of ESG ratings. The Head of the European Securities Market Authority has publicly advocated ESG ratings to be regulated in line with credit ratings.
- Regulation would likely contribute towards making the ESG –rating industry more professional and capable of delivering the value that is aims at.

'ESG rating agencies should be regulated': ESMA chief weighs in on data debate

Maijoor also called for corporate disclosure standards to be international

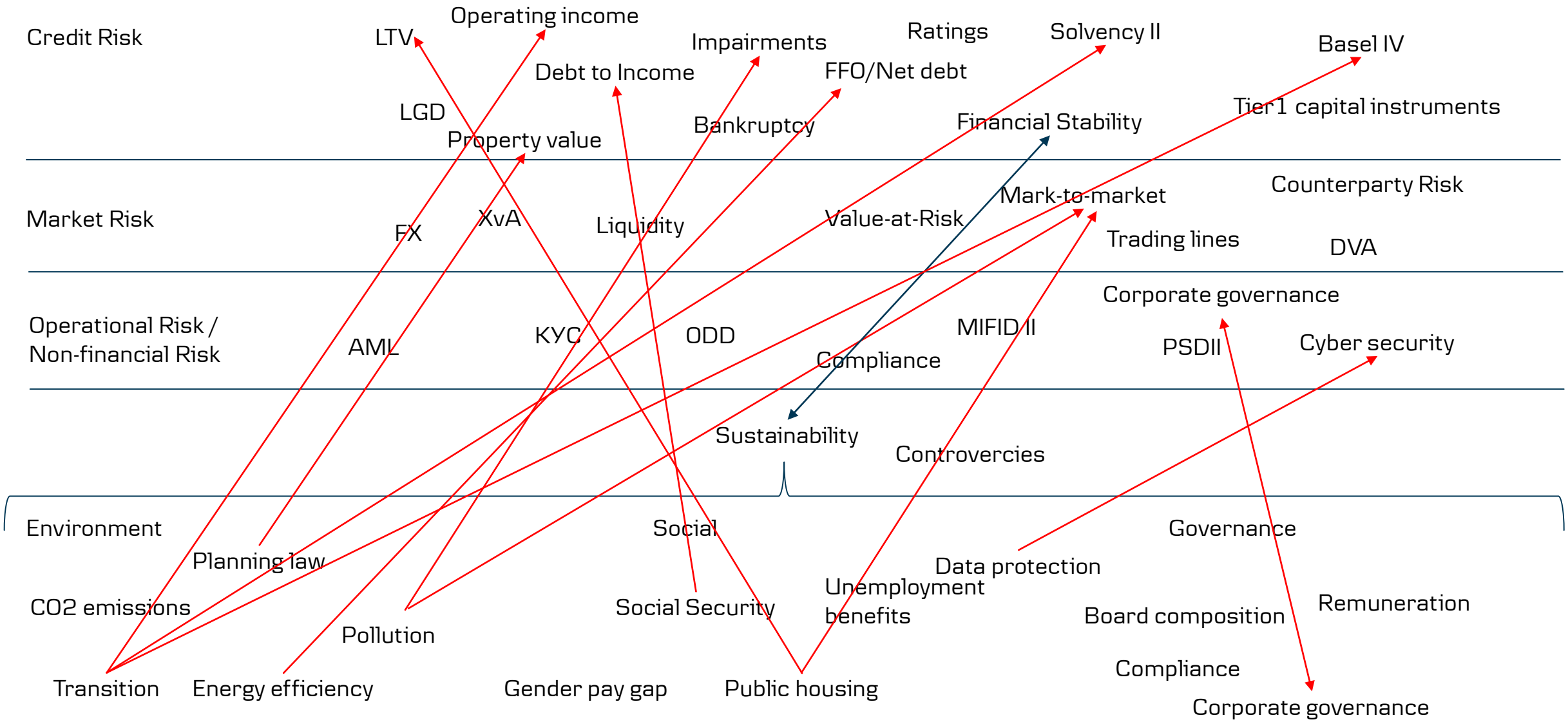
Is there thought leadership?

Future Fit Business (www.futurefitbusiness.org)

- The UK-based foundation Future Fit is advocating a self-assessment tool helping companies and organisations estimate their degree of sustainability according to a holistic analytical framework.
- This is different from the ESG rating industry in that it is based on systems science and not on whatever information happening to be available.
- It targets the organisation able to produce relevant data and is systematic, valid and reliable.
- This initiative is relatively new, but has nonetheless scored success with a number of leading Danish companies including Novo Nordisk, Coloplast, Ørsted and Mærsk.
- Conceptually this is the correct analytical approach to pursue, since it starts at the hart of the issue where data can be produced, but it will require active auditing as well as standardized publication of data to realize the full impact potential.

Appendices

An attempt to create order



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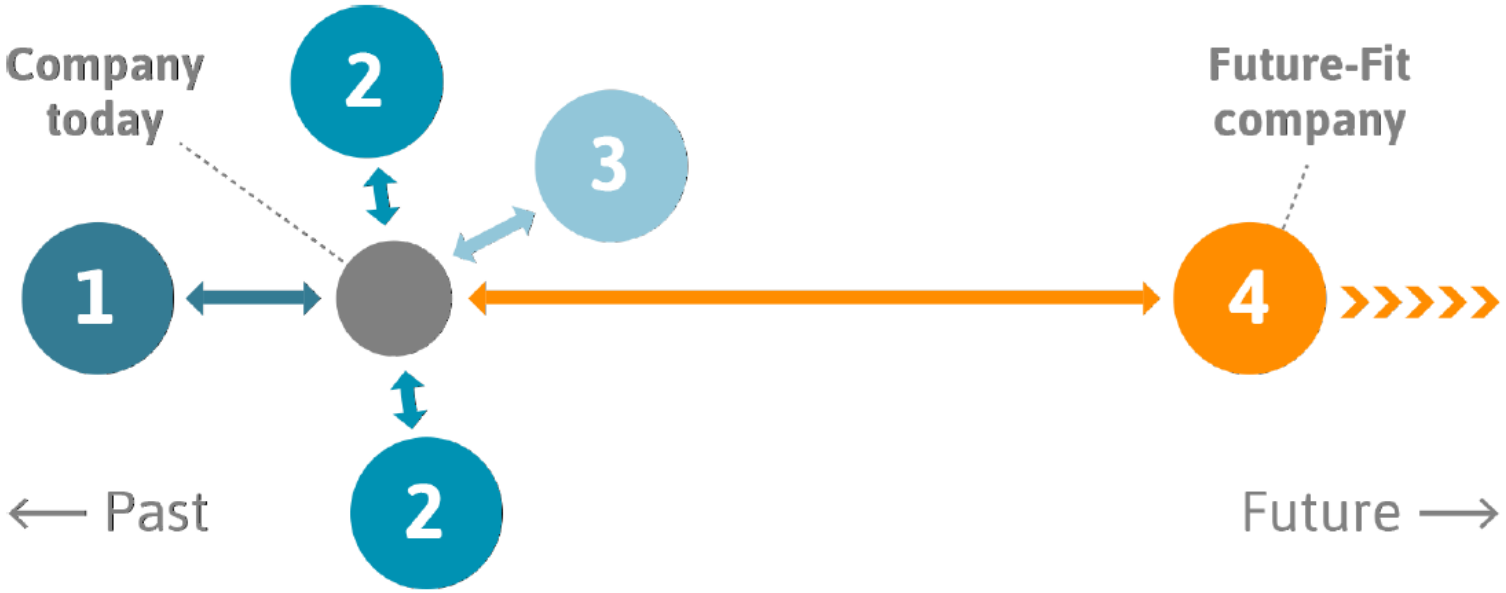
What Future Fit is about

A new kind of business benchmark is needed



1 Assessing company performance relative to a past year doesn't tell us where it is going

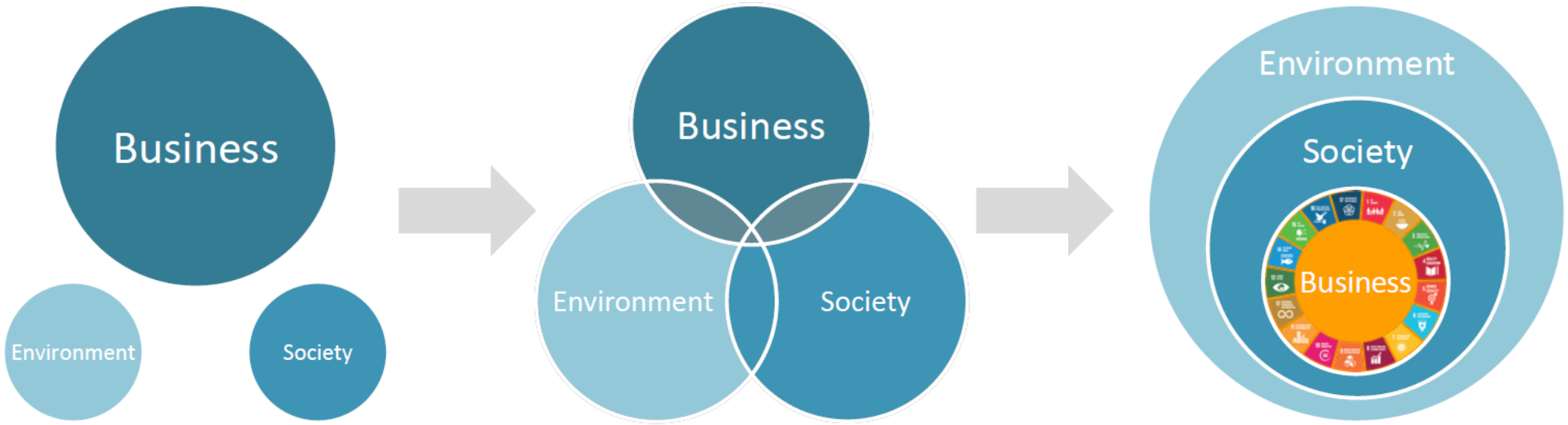
2 A focus on best practice by sector (e.g. current ratings) only drives a race to be 'least bad'

3 Progress toward short-term goals matters only if they contribute to the right long-term aims

4 For the full story we must assess progress toward and beyond an **extra-financial break-even point**

What does that entail?

We must rethink what we mean by "value creation"



Shareholder Value

Financial returns are all that matters: companies privatize gains and externalise losses

Shared Value

Business comes first: negative impacts are often not sufficiently internalised – or are justified – by 'doing good' elsewhere

System Value

Business addresses societal challenges in a holistic way, while not hindering progress toward a future-fit society

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What are the building blocks?

What would a Future-Fit Society look like?

Environmentally restorative, socially just, economically inclusive…

Energy is renewable and available to all

Water is responsibly sourced and available to all

Waste does not exist

Natural resources are managed to safeguard communities, animals and ecosystems

The environment is free from ***pollution***

People have the capacity and opportunity to lead ***fulfilling lives***

Our ***physical presence*** protects the health of ecosystems and communities

Social norms, global governance and economic growth **drive** the pursuit of future-fitness

Positive impact

Direct business impact

Indirect business impact

Any business may

create positive impact itself

by taking action to foster wellbeing or restore the environment

Any business may

amplify the positive impact of others

by helping them take action to foster wellbeing or restore the environment

Every business must

eliminate its own negative impact

by avoiding all actions that undermine wellbeing or degrade the environment

Any business may

reduce the negative impact of others

by helping them avoid actions that undermine wellbeing or degrade the environment

Negative impact

Future-Fit
Business Benchmark

Break-Even Goals

What every company *must* strive to do to *avoid slowing down* society's progress toward future-fitness

Avoid hindering the SDGs

		SDGs
Energy	**Energy** is from renewable sources	7, 13
Water	**Water** use is environmentally responsible and socially equitable	6, 12, 14, 15
Natural Resources	**Natural resources** are managed to … ecosystems, people and animals	1, 2, 8, 12, 14, 15
Pollution	**Operational emissions** do not **harm** people or the environment	3, 6, 11, 12, 14, 15
	Operations emit no **greenhouse gases**	13
	Products emit no greenhouse gases	13
	Products do not **harm** people or the environment	3, 6, 11, 12, 14
Waste	**Operational waste** is eliminated	11, 12, 14
	Products can be **repurposed**	11, 12, 14
Presence	**Operations** do not **encroach** on ecosystems or communities	1, 6, 11, 13, 14, 15
People	**Community health** is safeguarded	11, 16
	Employee health is safeguarded	2, 3, 5, 6, 8
	Employees are paid at least a **living wage**	1, 2, 3, 6, 8, 10, 11
	Employees are subject to **fair employment terms**	5, 8
	Employees are not subject to **discrimination**	5, 10
	Employee concerns are actively solicited … transparently addressed	5, 10, 16
	Product communications are honest … promote responsible use	12
	Product concerns are actively solicited … transparently addressed	12, 16
Drivers	**Procurement** safeguards the pursuit of future-fitness	1, 2, 3, 4, 5, 6, 7, 8, 9, 10, 11, 12, 13, 14, 15, 16, 17
	Financial assets safeguard the pursuit of future-fitness	1, 2, 3, 4, 5, 6, 7, 8, 9, 10, 11, 12, 13, 14, 15, 16, 17
	Lobbying and advocacy safeguard the pursuit of future-fitness	16
	The right **tax** is paid in the right place at the right time	9
	Business is conducted **ethically**	16

Future-Fit
Business Benchmark

Positive Pursuits

What any company *may* choose to do to *help speed up* society's progress toward future-fitness

Actively help the SDGs

Energy	Others **depend less on non-renewable energy**	7
	More people have **access to energy**	7, 9
Water	Others **contribute less to water stress**	6, 8, 12
	More people have **access to clean water**	6, 9
Natural Resources	Others **depend less on inadequately-managed natural resources**	2, 8, 9, 12, 14, 15
Pollution	Others generate **fewer greenhouse gas emissions**	13
	Greenhouse gases are removed from the atmosphere	13
	Others generate **fewer harmful emissions**	3, 6, 11, 12, 14, 15
	Harmful emissions are removed from the environment	3, 6, 11, 14, 15
Waste	Others generate **less waste**	8, 11, 12, 14
	Waste is reclaimed and repurposed	8, 11, 14
Presence	Others cause **less ecosystem degradation**	2, 6, 11, 13, 14, 15
	Ecosystems are restored	2, 6, 11, 13, 14, 15
	Others cause **less damage to areas of high social or cultural value**	2, 11, 15
	Areas of high social or cultural value are restored	11, 15
People	More people are **healthy and safe from harm**	2, 3, 5, 8, 11, 16
	People's capabilities are strengthened	1, 2, 3, 4, 5, 8, 9, 10, 11, 12, 13
	More people have **access to economic opportunity**	1, 2, 5, 8, 9, 14, 15
	Individual freedoms are upheld for more people	3, 4, 5, 8, 10, 16
	Social cohesion is strengthened	8, 9, 10, 11, 16
Drivers	**Infrastructure** is strengthened in pursuit of future-fitness	1, 2, 3, 4, 5, 6, 7, 8, 9, 10, 11, 12, 13, 14, 15, 16, 17
	Governance is strengthened in pursuit of future-fitness	1, 2, 3, 4, 5, 6, 7, 8, 9, 10, 11, 12, 13, 14, 15, 16, 17
	Market mechanisms are strengthened in pursuit of future-fitness	1, 2, 3, 4, 5, 6, 7, 8, 9, 10, 11, 12, 13, 14, 15, 16, 17
	Social norms increasingly support the pursuit of future-fitness	1, 2, 3, 4, 5, 6, 7, 8, 9, 10, 11, 12, 13, 14, 15, 16, 17

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