The Significance of ESG Ratings for Socially Responsible Investment Decisions

An Examination from a Market Perspective

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1. Introduction

Institutional investors are becoming ever more aware of the potential risks and opportunities associated with environmental, social and governance (ESG) factors. From natural resource scarcity to changing governance standards, from supply chain and labor management concerns to evolving regulatory landscapes, it has become increasingly important for socially responsible investment (SRI) professionals to understand the ESG profile behind the assets they are managing. Hence, the access to relevant, consistent, comparable, balanced and reliable ESG information has become a prerequisite for asset managers to take the right investment decisions.

The financial services market has responded to this need by producing specific ESG ratings, rankings and indices. These services serve asset managers of SRI portfolios with the analytical information they would need to assess the ESG performance, risks, and opportunities of assets-under-management (AUM).

The objective of this research paper is to examine the relevance of ESG ratings for SRI decisions from a market perspective and to identify the dynamics that affect the development of the ESG ratings industry in the future. As ESG ratings are designed to shape SRI decisions, the paper will first examine the dynamics of the SRI market and its impact on the demand for ESG ratings by investment professionals. It does not intend to provide a comprehensive analysis of neither the SRI market nor the ESG rating services industry as a whole but remains focused on the role of ESG rating services and their significance for the SRI decision-making process.

The study is based on desk research and analysis of recent literature about socially responsible investment in general and the sustainability information market in particular, including academic studies and reports from governmental organizations, industry associations, think-tanks and NGOs as well as publicly available material from institutional investors. The literature review was complemented by a series of interviews conducted with representatives of regulatory authorities, institutional investors, finance sector industry associations, academics and NGOs. The purpose of these interviews was to gauge controversial statements made in publications, to learn about recent initiatives, or simply to explore the general context. A list of interviewees is available in the annex.

The paper is structured into three parts: Following this introduction, the main part consists of the

discussion of the chosen topic, before leading into final conclusions. As ESG ratings are related to the financial component of corporate sustainability rather than to regulation or implementation, the research will refer to the principles of SRI as a theoretical framework. To this end, it will first identify the driving forces of the SRI market and how these dynamics affect the demand for ESG rating sevices, before outlining the ESG rating market and the factors that might impact its further evolution.

2. Discussion

2.1 SRI Market Dynamics

Financial markets have an important role to play in moving companies forward on sustainability. Within this market, public and private pensions, insurance companies, sovereign wealth funds, mutual funds, banks and asset managers have about €57 trillion, or about 35 percent, of the world's financial assets under management *[BSR, 2012, p.5].* When it comes to ensuring socially responsible investments for a resource-efficient economy and sustainable growth, institutional investors represent a considerable economic force and source of finance for the economy. The shift to a new low-carton economy alone will require trillions of investment capital for new technologies. To achieve the 2-degree internationally agreed global climate goal, energy-efficiency investments need to be multiplied by a factor of five to eight by 2030, hence financial support from private investors will be paramount.

By definition, Socially Responsible Investment (SRI) is an approach to investment that explicitly acknowledges the relevance of ecological, social and governance (ESG) aspects as well as of the long-term health and stability of the market and society as a whole. ESG factors are a subset of non-financial performance indicators. They recognize that the generation of long-term sustainable returns is dependent on stable, well-functioning and well governed social, environmental and economic systems. ESG can be defined as a "set of standards for a company's operations that socially conscious investors use to screen investments. Environmental criteria looks at how a company performs as a steward of the natural environment. Social criteria examines how a company manages relationships with its employees, suppliers, customers and the communities where it operates. Governance deals with a company's leadership, executive pay, audits and internal controls, and shareholder rights." *[Investopedia, 2016]*

SRI differentiates itself from conventional investing approaches by the objective of creating sustainable, long-term investment returns, and the need for investors to pay attention to the wider contextual factors, including the stability and health of economic and environmental systems and the evolving values and expectations of the societies of which they are part. *[UN/PRI, 2015, p.3]* In doing so, investors are able to make better investment decisions and improve investment performance with the result that capital is being allocated towards well-governed companies that contribute to the goals of a more sustainable economy and society.

The global sustainable investment market has continued to grow both in absolute and relative terms, rising from €11.7 trillion at the outset of 2012 to €18.9 trillion at the start of 2014, and from 21.5 percent to 30.2 percent of the professionally managed assets. [*GSIA, 2014, p. 3]* This 61 percent growth outpaced the growth in total professionally managed assets. [*GSIA, 2014, p. 7*)] As SRI is becoming mainstream, investors take stock of ESG factors in equity investing and increasingly focus on fixed income as well. According to the Global Sustainable Investment Alliance (GSIA), 58.8% of total managed assets in Europe in 2014 were subject to some form of SRI strategy, where ESG, in combination with financial considerations, guide the selection and management of investments. This does not necessarily mean that the investments were sustainable, just that ESG issues were considered during the investment decision-making process. *[European Commission, 2014, p. 47]* Socially responsible investors comprise institutions, such as universities, foundations, pension funds, nonprofit organizations and religious institutions, as well as average retail investors to very high net worth individuals and family offices. It has been a feature of the SRI market in most of the regions that professional institutional investors dominate the market, but interest by retail investors in SRI is growing. [*GSIA, 2014, p. 9]*

The rising interest in responsible investment is being driven by a number of factors *[UNGC, 2015, p. 5]:*

1. The recognition that ESG issues are financially material to long-term investment performance

A growing body of academic research shows that strong corporate performance on ESG factors correlates positively with improved cost of capital and financial performance. [*SSE Initiative, 2015, p. 12].* Collaborative research examining more than 2,000 empirical

studies of ESG and financial performance over three decades found that 62.6% of studies showed a positive correlation between the inclusion of ESG factors in investment decision making and financial performance. *[Friede, 2015, pp.217-218]*[1]

2. Taking into account ESG factors into an investment analysis has become part of fiduciary duty

With more than 75% of public company value considered intangible today, up from only 18 percent in 1975, most of a company's worth comes not just from its assets or products, but from its reputation and other considerations closely related to ESG. *[Bob Willard, 2013]* This makes companies and their investors much more vulnerable to value collapses in the event of a high-profile problem. [SSE Initiative, 2015, p. 15] From an asset owner perspective, failing to consider ESG factors in long-term investment practice therefore is "considered being a failure of fiduciary duty." [*UNGC, 2015, p. 9]* As a result, the consideration of sustainability imperatives and ESG information into investment decisions is becoming common practice. A study from 2016 shows that nearly 75 percent of investors cite improved sustainability-related revenue performance and operational efficiency as strong reasons to invest in a company. *[Unruh, 2016, p.4]* Asset owners like pension funds, insurance companies, and sovereign wealth funds, which have long-term liabilities and a fiduciary duty to their members, are mandating asset managers to integrate ESG criteria across their portfolios.

3. Growing concern about the impact of short-terminism

For investors the framework of their investment portfolio is typically set by a peer group or index benchmark. This pattern has a number of negative impacts on investment markets, particularly in driving herding and short-term thinking. While long-term investors would allow companies to develop sustainable development strategies that are connected with the real needs of their business, money managers typically pursue a short-term perspective, as they buy and sell for today's market price. In order to avoid the the risk of disruption on company performance, investment returns and market behavior,

1 Studies with such findings have come from TIAA-CREF Asset Management, Empirical Research Partners, Envestnet PMC, Deutsche Bank Group Climate Change Advisors, GMI Ratings, Mercer, and the United National Environment Programme Finance Initiative, among others. These findings are corroborated by a research from Harvard Business School which found that companies that perform well on material sustainability factors, evaluated based on SASB criteria, enjoy enhanced market returns over firms that perform poorly on material factors. [Khan, 2015, p.26]

some asset owners adapt a longer-term investment approach considering ESG factors. James Montier from global investment management firm GMO argues that strict adherence to shareholder value has hurt long-term equity performance and the growth potential of the US economy. *[Montier, 2014, p.14]* This mindset is being seconded by sustainability leaders like Unilever, who in November 2010 announced that the company would stop giving quarterly earnings guidance so that they could focus on the development of a new and more sustainable business model. By doing so, the company signaled to the market the types of investors it wants to own its shares. [*BSR, 2012, p.8]*[2]

4. Public policy requirements for investors to exercise their responsibilities as owners

Apart from certain statutory provisions of public pension funds and sovereign wealth funds there are no general provisions that would require institutional investors to integrate ESG issues into their investment decisions policies. However, public policies are currently being developed to encourage asset owners to mandate their trustees to adopt a more active stewardship approach, e.g. through direct engagement, proxy voting, or impact investing.

5. Pressure from competitors seeking to differentiate themselves through responsible investment

Public companies see themselves under growing pressure by competitors that have already integrated sustainability into their business strategy. The same applies to investment funds that try to attract customers by adding SRI to their product portfolio. For investment funds and other financial services providers, the differentiation on ESG matters is quickly becoming a competitive imperative.

6. Ethical motivations of investors, clients and beneficiaries

The demand from asset owners who want to consider ESG criteria and wish to align their investments with their values without compromising on the performance side is continuously increasing. This is particularly accounts for millennials *[Jackie Vanderbrug,*

2 However, as Lydenberg points out, “part of the problem with the call for long-term perspectives and non-financial considerations is that market participants, because they buy and sell on today’s price, inevitably have, to a certain extent, a short-term perspective. To expect buyers and sellers to completely ignore the short-term implications of the price they are paying or receiving [is] unrealistic. *[Lydenberg, 2015, p. 19]*

2014].[3] As a result, investors are seeking less carbon-intensive and more environmentally and socially friendly portfolios.

7. Facilitation by non-governmental organizations

Socially responsible investors have managed to influence public policy and set-up organizations as facilitators to provide them with the necessary capacity, methodologies, frameworks and standards for ESG guidance, analysis, and reporting.[4] Policy developments and self-regulation - “particularly relating to corporate ESG disclosure - are likely to further facilitate or promote sustainable investing strategies.” *[GSIA, 2014, p. 26]*

SRI has grown significantly over the last years, exceeding the growth of most other investment strategies. Asset managers and investors are increasingly conscience of this trend and of the critical impact ESG factors can have on the long-term risk-and-return profile of their investment portfolios. In order to take this into account for their investment decisions, asset managers use one of the following SRI approaches or a combination of them *[USSIF Website: Misperceptions]*:

- Positive/best-in-class: Investment in sectors, companies or projects selected for positive ESG performance relative to industry peers
- Negative/exclusionary screening: The exclusion from a fund or plan of certain sectors or companies based on specific ESG criteria
- ESG integration: The systematic and explicit inclusion by investment managers of ESG factors into traditional financial analysis
- Impact investing: Targeted investments, typically made in private markets, aimed at solving social or environmental problems
- Sustainability themed investing: The selection of assets specifically related to sustainability in single- or multi-themed funds
- Share-owner engagement: Actions by sustainable investors to influence portfolio companies’ ESG policies and to make improvements on identified issues

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3 By some estimates, €26.5 trillion is going to pass from baby boomers to younger generations over the next half century. That money will move into the hands of investors who appear to be significantly more interested in sustainable investing than their elders. *[Jon Hale, 2016, p. 4]*

4 Leading non-governmental organizations include: CDP (formerly Carbon Disclosure Project), Ceres, Council of Institutional Investors, Global Reporting Initiative (GRI), CSR Europe, Principles for Responsible Investment (UN PRI), Global Initiative for Sustainable Ratings (GISR), United Nations Environment Programme’s Finance Initiative, Sustainable Accounting Standards Board (SASB), EuroSif, as well as other regional and national sustainable investment forums. *[USSIF Foundation, 2013, p. 4-5]*

While a study by the Global Sustainable Investment Alliance from 2014 identifies negative screening/exclusions (€12.7 trillion) as the most common SRI approach globally, followed by ESG integration (€11.4 trillion) and corporate engagement/shareholder action (€6.2 trillion), [*GSIA, 2014, p. 3]*, a more recent survey from 2015 among members of the the Chartered Financial Analyst (CFA) Institute shows that, with 57%, ESG integration has become the most popular method.[5]

Referring to a report published by BSR, both approaches - screening and full ESG integration - typically favor portfolios with stronger ESG rating scores when other financial performances are equivalent. As ESG integration and other responsible investment approaches are often complemented with standard engagement practices such as due diligence, getting to know management, understanding the culture of an organization as well as the future pipeline of products and services, BSR considers active ownership to be the "most prevalent" responsible investment activity among SRI practitioners. "In fact, the practice of monitoring corporate governance is typically considered to be a component of fiduciary duty within the mainstream financial community." *[BSR, 2012, p.5]*.

Despite differing views about the most popular method there is evidence for a trend towards more diligent SRI portfolio management compared to basic screening approaches. The implications of this phenomenon on ESG ratings will be examined in this paper at a later stage.

2.2. ESG Rating Market Overview

The discipline of sustainability research and analysis has been evolving since the 1990s. It assesses the environmental, social and governance performance of corporations, investment trusts, and other issuers of securities such as local governments, countries, or supranational organizations. ESG ratings, rankings and indices are designed to measure the performance and risk of these legal entities against ESG criteria. They provide a proxy for the external costs and benefits absent from conventional financial accounting and reporting systems. ESG analysis is

5 Sample size: 1,325 portfolio managers and research analysts (members of CFA Institute), Survey time frame: 26 May–5 June 2015] "This finding contrasts sharply with the perception that ESG issues are only about the exclusionary screening of 'sin stocks' (alcohol, tobacco, and gambling)." [*CFA Institute, 2015, p. 28]*

primarily based on publicly available data from various sources: the companies themselves (CSR reports[6], public documents, specific questionnaires, telephone and face-to-face contact), stakeholders (NGOs, trade unions, governmental organizations, etc.) and the media.

ESG ratings establish an overall score, or grade, which positions the company on a particular rating scale. Designed to indicate a company's sustainability performance, the ESG score is based on a set of predefined sustainability criteria and weighted according to degree of importance. Asset managers can refer to the score when designing and managing investment portfolios, depending on their specific selection approach. As a result, ESG ratings help capital providers to distinguish firms that are superior to their peers in terms of risk management and corporate governance. [*Allen White, 2015]*

Major international rating agencies most often offer a range of products that generally includes company ratings, country ratings and analyses of compliance with standards (norm-based analysis). Some ESG rating firms also provide raw data that can be linked into investors' own client analysis tools and financial data. Others provide on-demand CSR audits in addition to rating services. *[Novethic, 2014, p.6-8]* Unlike financial rating agencies, ESG rating firms are typically paid by investors and not by the rated entities. This type of rating is also referred to as a "declarative rating", as opposed to a "solicited rating", where the ESG audit is performed at the request and the expenses of a company or some other sponsor.

The sustainability information market includes some 135 providers of ESG ratings, rankings or indices *[GISR website, 2016]* covering more than 50,000 companies on about 10,000 performance metrics - a glut of sustainability data that has helped lead to more than €18.9 trillion in sustainability-oriented assets under management. With €220 million in turnover, the ESG information market compared to the total number of socially responsible AUMs is relatively small. Nevertheless, the Global Initiative of Sustainability Ratings (GISR) sees a potential to quadruple its current size to €882 million. *[Hower, 2015]*

Due to a number of mergers and acquisitions over the past years, the ESG rating market has become more concentrated. In early 2016, the six leading non-specialized ESG rating providers include Inrate (Switzerland), MSCI ESG Research (US), oekom Research (Germany), Solaron

6 In 2015, 89 percent of Fortune 500 companies published some form of sustainability report. *[Weinreb Group, 2016, p. 4]*

(India), Sustainalytics (Netherlands), and VigeoEIRIS (France and UK). This consolidation can be explained by a business model that has grown more complex due to the focus on establishing independence from the issuers reviewed and the financial instability of the pioneer agencies. *[Novethic, 2014, p.5]*

The steady growth of the ESG information market is fueled by the rising demand from investors to assess ESG related risk and opportunities by comparing quantitative metrics and consolidated scoring in real time. As a result, a range of asset managers use sustainability analyses and ratings in managing their portfolios, including pension funds, insurance companies, portfolio management companies under mandate, and investment companies acting for institutional investors or individuals [*ORSE, 2012, p.50].* Apart from institutional investors, ESG research and rating providers also work for corporate clients, local authorities, public bodies or NGOs. Investors apply ratings to portfolio management, NGOs to design campaigns and business partnerships, and regulators to monitoring compliance with securities rules. *[White, 2012, p. 7].* Interviews performed in the context of this research showed that the primary customer segment for ESG research and rating firms are organizations that do not have the internal resources or expertise to analyze and interpret material ESG information on their own. Newer and smaller players tend to rely more heavily on external agencies although employing an in-house expert or two is becoming more common. *[SRI Services, 2016]* Institutional investors and large financial services firms with in-house analysts privilege renown ESG research companies to purchase data sets of high quality for proper assessment rather than relying on precast ESG scores.

For corporations, on the other hand, ESG rating scores and rankings are important to top executives primarily for performance reviews and compensation decisions, and secondly for reputational reasons. According to a survey by ESG rating provider oekom Research, almost nine out of ten rated companies see it as important or even very important to be awarded a good sustainability rating or to be included in sustainability indexes and funds. *[oekom, 2013, p. 7]* Even though they complain about the time effort and expenses of fulfilling survey requests from different ESG rating firms – the so called 'survey fatigue' - the majority acknowledges the value of ESG questionnaires as a management tool and an opportunity to communicating with investors about their sustainability performance and initiatives on a regular basis. *[White, 2012, p. 5]*

The breadth and depth of ESG data that investors base their investment decisions and actions on varies substantially. [*UNEP 2015, p. 11]* A survey by the CFA Institute indicates that globally

73% of professional investors say they take ESG factors into account in investment analysis and decisions *[CFA Institute, 2015, Guide, p. 11]*. This includes any type of SRI approach, from exclusionary screening to active engagement. About 86% of asset owners and managers from PRI signatories use more than one source for ESG analysis, with ratings being one of them. In addition to utilizing public data, 66% of investors refer to third-party providers to obtain relevant ESG information for their investment decisions. *[CFA Institute, 2015, Myths, p. 2]*

However, as portfolio managers seek to protect their strategies as trade secrets to maintain a competitive advantage, there is little evidence about the extent to which they actually draw on ESG rankings, ratings and indexes in business practice. An investigation by RobecoSAM found that the vast majority of asset owners expected their managers to integrate ESG considerations into investments, but that few asset owners carried out comprehensive due diligence to ensure that their managers were equipped to do so. The majority of asset managers indicated that they integrate ESG factors into their investment process, but a minority reported that their investment teams work with raw ESG data, which the PRI views "as a prerequisite to effective, value-adding integrated analysis". *[PRI, 2015, p. 31]* BSR found evidence that the actual utilization of ESG data remains limited in the fact that only about 3 percent of subscribers to the Bloomberg Terminal Intelligence platforms actually consult Bloomberg's ESG database.[7] BSR sees this as a "proof that investors have not yet figured out how to systematically integrate ESG information into their investment decision-making process."*[BSR, 2012, p.4]*.

2.3. Factors Affecting the ESG Rating Market

This section outlines the influencing factors that impact the significance of ESG rating scores for SRI management decisions carried out by institutional investors. In essence, the two major driving forces of the sustainability information industry are regulation and market dynamics.

Policy makers around the world recognize the importance of strengthening market mechanisms that will help achieving objectives related to sustainable development. In order to understand te long-term potential of companies, investors want them to disclose more in depth information that explains the relevance of disclosed topics to corporate strategy with a highlight on opportunities and risks. A study found that 82% of investors are dissatisfied with how risks and opportunities

7 Bloomberg Terminal subscriber base: 325.000, ESG users (2011): 4.000, ESG users (2015): 12.000 (=3%)

are identified and quantified in financial terms, 79% said they are dissatisfied with the comparability of ESG reporting between companies in the same industry. *[PwC, 2015, p. 1]* As a result, a number of regulatory requirements have been introduced to drive the disclosure of corporate ESG information, - the primary source of information for ESG research and rating providers. In Europe, the EU-Reporting Directive 2014/95/EU on disclosure of non-financial and diversity information - also known as EU NFR or Accounting Directive – legally requires companies with 500 employees or more to publish a 'non-financial statement' as well as additional disclosures around diversity policy as of January 2017. In France, the Energy Transitions law introduced in 2016 requires portfolio managers to report on the environmental profile of their funds, including ESG issues as well as information on carbon footprints and green revenues. Although the reporting requirement is voluntary, investors either must publish relevant disclosures by the end of 2017 or explain why they have chosen not to do so.

In addition to that, a series of international initiatives, standards, and experts exist to ensure a certain level of availability and quality of ESG data. International organizations like the Global Reporting Initiative (GRI - G4), the United Nations Global Compact, the Sustainability Accounting Standards Board (SASB), the International Integrated Reporting Council (IIRC), or the International Standards Organization (ISO 26000) – to name only a few - provide corporations comprehensive frameworks and de facto standards for ESG reporting and assessment. The Global Initiative for Sustainable Ratings (GISR) and the ARISTA 3.0® international standard (formerly known as CSRR-QS 2.1®) have been developed to help ESG research and rating providers incorporate the key principles of quality, integrity, transparency and accountability into their research processes. [*Eurosif, 2014, p. 35].* However, while the quantity of ESG data is constantly growing, ESG research firms are faced with a number of challenges regarding the accessibility and quality of accurate, relevant, and meaningful ESG information for their rating exercises. Despite all regulatory efforts, the implementation of the above mentioned reporting frameworks and standards remain voluntary. At this stage, there are no universally accepted ESG reporting, auditing, or accounting standards like there are for financial data.

This also accounts for the disclosure of predictive, context-related and materiality information that are essential for the ESG assessment and rating process. When ratings over-rely on past performance and under-represent indicators that predict future company performance, investors and other users are left with a deficit on insight as critical questions remain unanswered. [*White, 2012, p. 5]* This deficit deepens when materiality information about ESG issues that matter most

to a business and its stakeholders is missing or not being taken into account adequately in ESG rating calculations. Like in financial reporting, materiality is a fundamental guiding principle in order to narrow down what information is required to assess the potential risks associated with an investment. [*EU, 2014, p.63]* The identification of material ESG information requires a structured process that explicitly incorporates the subjective judgments of internal and external stakeholders and yields an internally consistent ranking of ESG topics by their relative importance to the company's long-term performance.[*Deloitte, 2013, p. 14]* Materiality, at its essence, is entity-specific, audience and time frame dependent, and based ultimately on the judgment of the board of directors. [*Eccles & Youmans, 2015]* For many potentially material ESG issues, valuation is difficult, missing, or based upon assumptions that are often challenged. Consequently, prioritizing and selecting material ESG topics is a highly subjective exercise, which is why interpretations of what is material vary greatly. Many companies disclose only a handful of indicators, and few explain why an indicator is not disclosed. *[Deloitte, 2013, p. 7]* In their "Rate the Raters" empirical study from 2010, SustainAbility conclude that "it is difficult to gauge how well raters evaluate the most material issues in sectors as few raters disclose (publicly or to us) how their scoring schemes accommodate sector-specific criteria. However, from what we know about typical ratings processes and company engagement, it is unlikely that many ratings are able to judge companies closely on what we would consider to be their most important issues."[*SustainAbility, 2010, Phase 3, p. 24]*.

Even though there is agreement among investors and corporations on the growing importance of a materiality analysis for defining the most important sustainability issues, the GRI recognized that the identification of material ESG topics is one of the most difficult, underdeveloped, and least systematized aspects of reporting for many companies. [*Deloitte, 2013, p. 9]* It responded to this challenge by incorporating materiality factors in its 2015-2020 strategy. The GRI "G4" reporting framework extended its scope from retrospective sustainability reporting to focusing on capturing value opportunities.[8] The SASB rigorously defined materiality factors at sector and industry levels and is pushing for disclosure of material ESG factors in IPO and 10-K filings.[9]

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8 A research by GRI and RobecoSAM among companies from the Mining, Metals, and Electric Utilities industries finds that the G4 approach to materiality for these particular sectors is appropriate to investors as a basis for disclosure, even though asset managers would require more in depth information on strategic relevance for proper decision making. *[GRI, 2016, p.6]* BlackRock's recently published views on ESG issues notes that G4 guidelines list "over 400 indicators on corporate sustainability performance" and include "factors that go beyond investment-related issues." As a result, comparing the performance of companies under the GRI approach will continue to be difficult, if not impossible. *[SASB, 2016, p. 21]*

9 In a formal response to the SEC's public comment on a concept release on disclosure reform, the SASB emphasizes that mainstream "investors increasingly seek better disclosure of sustainability-related

However, as long as materiality is not universally incorporated into ESG disclosure in a standardized, comparable way, Eccles concludes that “broad-based sustainability indices are not materiality indicators, and thus are not material themselves. [*Eccles & Youmans, 2015]*

One other challenge about ESG disclosure is the assurance of data accuracy, as it might affect the quality and reliability of ESG rating results. Considering the fact that more than two-thirds of investors have lost trust in company reports since the onset of the global financial crisis [*IIRC, 2014, p. 8]*, a report by the GRI states that the percentage of extra-financial reports with a “high”or “reasonable” level of data assurance remains rather small (7% of all reports registered in the GRI database in 2012) *[GRI, 2013, p. 12]*. This is mainly due to cost constraints and other feasibility issues.[10] In order to stimulate a higher level of ESG data accuracy, the former Carbon Disclosure Project (CDP) and the Dow Jones Sustainability Index (DJSI) started awarding additional “points” to companies for obtaining external assurance. However, many corporations remain skeptical about standardized ESG reporting or the publication of significant ESG information partly because they don't see a tangible entrepreneurial benefit, and partly because they want to guard against potential legal and competitive risks. [*Deloitte, 2016, p. 3-6]* According to SASB, about 75 percent of ESG information reported in sustainability reports is not material, while 90 percent of known negative events are not disclosed. *[Rogers, 2016]* These reports were found to “camouflage real sustainable-development problems, presenting an idealized version of company situations.” *[Boiral, 2013, p.1061]* Research of over 4,000 sustainability reports carried out by Deloitte from 2005–2009 finds a significant number of data omissions, unsubstantiated claims, and inaccurate figures. “Surprisingly, there is limited disclosure of compliance costs, which is mandated in many jurisdictions by regulatory entities (erg. the United States EPA’s ECHO database).” [*Deloitte, 2013, p. 12]* In view of missing or non-validated information, ESG rating results become subject to interpretation by ratings users, who need to exercise their own judgment as to the accuracy and quality of scores. Rating provider CSRHub, for example, state that “we are not presenting “truth” or externally verified data, but instead “perception” and what is “generally known” about the companies we rate.” [*SustainAbility, 2013, p. 4]*.

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information. While Regulation S-K already requires the disclosure of material information, the resulting disclosure of sustainability-related information is insufficient. To make sustainability disclosure more cost-effective for companies and decision-useful for investors, we need a market standard." *[SASB 2016, p. 1]*

10 Assurance providers often offer two levels: ‘reasonable assurance’ (e.g. high but not absolute) or ‘limited assurance’ (e.g. moderate). The higher the level of assurance, the more rigorous the assurance process is, as defined in the standards and procedures used for the specific assurance engagement level of assurance formally verified by a third-party remains limited. *[GRI, 2013, p. 9]*

In addition to that, what impacts the accurate measurement of a company's sustainability performance is the absence of ESG accounting standards and the fact that some information about strategy, environmental and societal impacts, and ethical performance cannot be translated into financial metrics. Even though the external environmental costs of a company's operations give a good long-term indicator of the environmental sustainability of the company's activities, *[Green Biz, 2016, p. 81]*, there are no commonly acknowledged measurement standards today to calculate the value of natural capital or ecosystem services consumed by a business. As Lydenberg points out, the "valuation of non-financial assets or capitals is challenging, with economic and accounting flows serving as the most convenient tool for value measurement; relevant non-economic or accounting data being difficult to define and gather; and the incorporation of this additional data tending to complicate comparability." *[Lydenberg, 2015, p. 13-14]*

While performance indicators across ESG topic areas do not distill down into one standardized unit of measure, as is the case with the dollar in traditional financial reporting, [*European Commission, 2014, p. 56]* investment managers and major accounting firms – most notably the "Big Four" business consultancies[11] - advocate the introduction of standards for material sustainability data as an equivalent to traditional financial data: "Just as the accounting profession set standards in the 1970s for reporting financial information, sustainability accounting standards for factors such as energy consumption, fair labor practices, data security, and supply chain management are needed to fairly represent a company's performance." *[Deloitte, 2016, p. 5]* However, Deloitte recognizes the fact that "while valuing an ecosystem may be possible at a macro level, allocating between consuming entities is much harder. For many of these natural capital assets and services there is no market price."*[Main & Oppenheimer, 2012, p. 133f]*.

Without standards, the incorporation of context-related ESG data, representing an organization's impacts on vital capitals and the stakeholders that depend on them, into materiality and sustainability ratings will remain subject to controversy. Searcy emphasizes the fact that "measuring corporate sustainability requires an explicit connection between a company's performance and the ability of nature and society to indefinitely support its activities. This is currently missing in the slew of popular sustainability ratings. Rankings based on absolute or relative measures are laudable efforts that are interesting and useful, but they do not allow us to

11 *Pricewaterhouse Coopers (PwC), Ernst & Young (EY), Deloitte, KPMG*

separate sustainable and unsustainable corporations."*[Searcy, 2016]*

Some other critics stress the fact that rating providers for commercial reasons remain averse to standardization of measurement and scoring methodologies to protect their proprietary business model and intellectual property. Specific KPIs, normalization methods, and weighting schemes tend to vary considerably from one rating to another. Some raters given companies a numerical score (erg. between 0.0 and 1.0). Some use "+" or "-" signs, others offer only a relative ranking (e.g. "Top 50" or "Best Performing"). Some rating providers focus on certain types of companies, industries, regions, or specific aspects of corporate ESG performance. Others concentrate on products and subsidiaries. Due to mergers and partnerships among ESG data providers, some have changed the way they calculate certain sustainability scores. Also, some ESG research firms only update their information only once per year, so if a controversy arises regarding a particular company, it may take as much as two years for its effect to be reflected among all scoring results. SustainAbility therefore call on rating providers to provide more transparency : "Raters expect transparency from companies, yet they too often fail to live up to the same expectation themselves. (…) While we recognize the proprietary nature of many ratings, and that limiting disclosure may be commercially necessary for organizations, the need for greater transparency persists." *[SustainAbility, 2010, Phase 1, p. 4]* [12]

Even though organizations like ARISTA and GISR provide ESG research and rating firms with codes of conduct to help them warrant the quality of their ESG research and ratings, these initiatives are of voluntary nature and do not aim at standardizing rating methodologies or scales. Despite the fact that a call for uniformity may inhibit innovation, it remains difficult for socially responsible investors to seize the full value of ESG rating information without legally binding standards for full ESG reporting, accounting, auditing, and ratings. If rating frameworks and scales were standardized, "the buyer of the sustainability rating could simply insert the standardized data in its investment decision-making process, in accordance with its management style." [*ORSE, 2012, p.43f]* By consequence, socially responsible investors use ESG rating scores as a nonbinding indicator rather than an intrinsic source of information, knowing that it remains their fiduciary responsibility to take into account the strengths and limitations of the

12 The report quotes Suzanne Fallender, Director of CSR Strategy and Communications at Intel Corporation: "When too little information is provided, it undermines the credibility and usefulness of the rating — there is no context to understand why companies are listed or not listed. The end result is that the rating is then not used within companies to drive performance improvements, which I see as the main value/contribution of these ratings." *[SustainAbility, 2010, Phase 3, p. 31]*

organizations supplying them. *[SICM, 2016, Insights, p.6]* Apart from the limitations of ESG rating scores outlined above, asset managers are also exposed to the single-source issue when relying on a specific ESG rating service only, as they might feel encouraged to invest into highly rated stocks rather than analyzing companies or funds with lower scores in order to validate them. Working with multiple providers, on the other hand, might be a challenge due to extensive subscription costs and the incompatibility of scoring methodologies.

In addition to regulatory efforts, the evolution of ESG rating services is directly influenced by the momentum of the financial markets. As outlined above, the demand from clients who want to consider ESG criteria to align their investments with their financial return goals and ethical values is continuously rising. The 2014 PRI Report on Progress showed that 67% of asset owner signatories ask their investment managers to integrate ESG issues into their investment processes. For listed equities, 83% of investment managers and 73% of asset owners reported that they integrated ESG issues into their investment portfolios, to at least some degree *[PRI, 2014, p.19]*. One year later, the proportion of investment managers incorporating ESG into decision-making grew to 95%, even though only 43% of them do so as part of a fundamental analysis of company valuation. *[PRI, 2015, p.22]*

With the rise of ESG integration as the most popular SRI method next to screening, asset managers are expected to adopt a more active approach for portfolio management. While some of them rely on on "third-party rating agencies to analyze companies' ESG disclosures and do not necessarily ask companies for ESG information" *[BSR, 2012, p.9]*, others refer to sustainability information for proper analysis and investigation purposes. Considering the trend towards ESG integration and active stewardship, the need for asset-managers to build capacity is becoming more pressing. [13] At the same time, it remains that finance enjoys a privileged status, free of the kind of regulation applied to many other sectors *[Blowfield, 2011, p.254]*. In this setting, asset managers are free to chose their own SRI approach without the need for justification towards their customers. Besides certain statutory provisions of public pension funds and sovereign wealth funds, there are no general provisions that require institutional investors to integrate ESG issues into their investment decisions. [*CFA, 2015, p.30]* Those skeptical about the benefits of ESG integration may be inclined to continue their conventional

13 In regards to capacity building, McKinsey advocate an industry-wide ESG certification that could become a signal of qualification to institutional investors as they hire and invest: "Bloomberg, the CFA Institute, the SASB, and many universities already offer ESG courses, and some consolidation around a clear industry qualification would benefit everyone." *[Bailey, 2016]*

investment approach rather than pursuing proper ESG research or drawing on ESG rating services.[14] Farsighted institutions are already building systems to rate external managers more thoroughly, but a shared system would multiply the benefits considerably. *[Bailey, 2016]*[15]

This situation on the demand side might explain why the size of the sustainability information market related to the total volume of SRI under management is relatively small. At the same time, the need for investors to better evaluate investments by ESG issues, particularly at portfolio levels, stimulates competition between financial service providers, resulting in new services and market consolidation, as shown by the acquisition of GMI Ratings by MSCI Research in 2014 or the merger of Vigeo and Eiris in 2015.[16] The consensus view is that the sector will consolidate further, with perhaps only a handful of ESG research and ratings providers eventually dominating. *[SICM, 2016, Insights, p.2]*

This trend goes along with a growing integration of extra-financial services by traditional financial data providers *[Novethic, 2014, p. 3]* as well as the creation of new ESG-related products and services. By the beginning of 2016, about 86% of global stock exchanges offer sustainable indices, a total of 200 globally, such as the Financial Times' FTSI4Good, the Dow Jones Sustainability Index (DJSI), or the MSCI ESG Indexes, to name only a few. Most sustainable indices are established by ESG rating agencies, based on their own ESG analysis and stock-picking methodology. These indices can be used as a basis to compare the performance of SRI funds or even to build new ones. *[European Commission, 2014, p. 44]* Brokers, the traditional providers of financial analysis on companies, have also begun to offer non-financial analysis by setting up dedicated teams. *[Novethic, 2014, p.4]*

Apart from individual stocks, ESG rating also finds its way into equity fund management. Morningstar Sustainability Rating is the first set of ESG ratings applied to mutual funds, including ratings and related ESG metrics for approximately 20,000 funds globally. In order to

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14 According to a study published by the European Commission, “many of the top management teams of asset management companies seem to not be convinced of the benefits of integrating ESG issues in their day-to-day activities.” *[European Commission, 2014, p.61]*

15 In order to see through the obfuscation that plagues some managers’ activities, a number of institutions have put in place mechanisms to increase fiduciary accountability. The New York Common Retirement Fund, for example, recently developed a comprehensive scoring system based on the best available benchmarks, penalizing managers that don’t provide transparency with poor marks. *[Bailey, 2016]*

16 Vigeo and Eiris merge to form VigeoEIRIS in 2015, Sustainalytics buys ESG Analytics in 2015, MSCI buys GMI Ratings in 2014, GMI forms from merger of Governance Metrics International, The Corporate Library and Audit Integrity in 2010, MSCI buys RiskMetrics 2010, Bloomberg buys New Energy Finance in 2009, Thomson Reuters buys Asset 4 in 2009

calculate a equity fund's portfolio sustainability score, Morningstar gathers individual company ESG scores in the funds, which are calculated by Sustainalytics. The initiative is significant because of the company's reach: Many investors use Morningstar's fund ratings, which look at performance or factors such as investment strategy and price, when making investment decisions. *[Mooney, 2016]* MSCI soon followed suit, expanding its ESG research coverage to include exchange traded funds (ETF) and mutual funds. Its ESG Fund Metrics rates 21,000 funds on factors such as long-term "sustainability impact, values alignment and ESG risks". Each fund is given an overall score, a percentile ranking, and individual scores for ESG. *[SICM, 2016, Trends, p. 2]* In 2016, Morningstar intends to add sustainability scores at portfolio level using data from Sustainalytics. This would give investors the ability to evaluate and compare "conventional funds with self-identified sustainable funds, as well as to choose funds based on whatever level of sustainability score they desire" to form a sustainable portfolio for the client. *[Hale, 2016, p.6]*

The market potential for fund rating is significant, as only 2% of all mutual funds are based on ESG considerations so far. For the fixed-income market, the investment management provider BlackRock announced the launch of a sustainable bond exchange-traded fund (ETF) in response to growing demand for investments that incorporate ESG factors. *[BlackRock, 2016]* A positive drive for ESG rating services also comes from so called "green bonds".[17] Issuers include development banks, municipalities and large corporations who may be expected to disclose information on financed green projects regularly, before and after the issuing of green bonds. As many of these bonds are 'self-labeled' in the absence of a market standard, some issuers are asking for an overall ESG rating from an independent third party, alongside their financial rating, to demonstrate their 'green' commitment. [*Eurosif, 2014, p. 32]*.

Another potential growth area for ESG ratings might as well be credit rating agencies (CRAs)[18]. Their primary purpose is to give an accurate assessment of credit risk for large-scale borrowers that issue bonds and other securities, including corporations. A survey by the Principles of Responsible Investment (PRI) shows that an increasing number of investors expect credit raters to incorporate ESG factors in a more transparent way, so they can better compare and contrast forward-looking credit rating analyses. By not factoring in the risks and opportunities ESG

17 The value of green bonds issued in 2015 was €37bn, up from €3.5bn in 2010. *[CBI website 2016]*

18 The CRA landscape is by and large diverse with a number of CRAs, but the three most recognized are S&P Global Ratings, Moody's Investors Service and Fitch Ratings, who together control 95% of the global market.

factors could have on investments, credit raters are prone to over-inflating the financial ratings and value of companies that perform low on long-term sustainability goals, thus putting investors at risk, and opening themselves up to potential legal liability. [*Moodie, 2015*] Commenting on the future, Standard & Poor's believe that environmental and climate risks will likely grow and "could lead to a more widespread weakening of corporate credit profiles and subsequently more downgrades than in the past". *[Petkov & Wilkins, 2015]* In order to comply to customer demand for more transparency and to demonstrate market and ethical leadership, Standard & Poor's and Moody's Corporation in 2015 already updated their overall credit rating methodologies by incorporating ESG risk assessments qualitatively and quantitatively into their credit rating methodologies. [*Ceres, 2014*] While the consideration of material ESG factors in the risk assessment process has a certain tradition, CRAs now formalize this practice in their rating methodologies, e.g. by introducing industry-specific ESG-scorecards and comparative rating grids.

At the same time, the PRI launched a global voluntary initiative funded by the Rockefeller Foundation that calls on ESG research and rating services as well as fund and CRAs to consider ESG factors in a more systematic and transparent way through the formal integration of ESG factors into financial ratings. Through May 2016, 100 investors managing €14 trillion of assets, and six credit rating agencies[19] have signed an according statement. *[PRI, press release, 2016]* Its purpose is to align non-financial and financial rating systems rather than to create common rating standards. According to PRI, the initiative allows CRAs to maintain full independence in determining which ESG criteria may be material to their proper ratings. “While issuer ESG analysis may be considered an important part of a credit rating, the two assessments should not be confused or seen as interchangeable.” *[PRI, Statement, 2016]* The ultimate goal of the initiative is to work out a common scoring standard for ESG ratings, rankings and indices by 2018, which might become a significant driver for SRI and the business case of ESG rating services.

In addition to the creation of ESG related services, alliances are being struck between established financial service providers and ESG raters, impacting on indices, listing requirements, bond ratings and proxy voting. Besides their strategic partnership with Morningstar, Sustainalytics also collaborate with global business and financial information and news leader Bloomberg, enabling them to integrate ESG profiles of approximately 1,600 companies, ranked against their industry

19 S&P Global Ratings, Moody’s Investors Service, Dagong, Scope, RAM Ratings and Liberum Ratings

peers across 15 performance indicators, into the Bloomberg professional services platform.

In 2016, S&P Dow Jones Indices and sustainability investment firm RobecoSAM launched the S&P ESG Index Series, the first index family to treat ESG as a standalone performance factor. Following a best-in-class approach, their "Smart ESG" methodology claims to account for financial materiality factors by "eliminating known biases such as market cap, industry and regional biases". The index is based on RobecoSAM's proprietary database of publicly available ESG corporate information provided by ESG research firm RepRisk ESG Business Intelligence. *[S&P Dow Jones, 2016]*

Due to this type of cooperation, the traditional providers of financial services can progressively develop in-house ESG expertise, while specialized ESG ranking agencies are able to increase their market reach. The latter respond to this challenge by adapting their service models accordingly. Apart from providing ESG ratings to their own customer base, they enter partnerships with other third-party providers to offer complimentary value-added-services such as engagement, controversy alerts, reporting, bond verification and investment consulting. ESG rating providers like Oekom Research help to assess Green Bonds in terms of their compliance with the Climate Bond Standard, a screening tool for investors and governments to prioritize climate and green bonds with confidence that these funds are being used to deliver climate change solutions. Engagement services consist in identifying major engagement themes based on corporate ESG analyses, and in guiding investors in their dialogue and engagement process. Oekom Research entered a partnership with GES, a provider of engagement services, to help asset managers define and implement their integrated SRI strategies. *[GES, 2015]* Customers can draw on GES' engagement services while, in return, GES clients gain access to oekom ESG rating information. Since 2014, GES "assists oekom in its companies rating and uses these data to define the dialogue policy inside its Engagement Forum." [*Novethic, 2014, p. 37]*

While the "battle to grade ESG investments" is heating up *[Lemos Stein, 2016]*, product diversification and collaboration gives rise to increasing competition and market consolidation. In this trend, leading CRAs like S&P Global Ratings or Moody's have the advantage of being well-established and highly acknowledged within the finance industry, as many asset managers draw on credit rating services as part of a financial assessment procedure. Moreover, CRAs command over a large number of analysts who gather financial and non-financial information through analytic research and direct engagement techniques. Moody's, for example, employs

1.300 experts globally for this very purpose. However, even though CRAs traditionally have been considering material ESG factors as part of their holistic assessment approach, they focus on credit risk rather than on ESG opportunities. Due to the “issuer pays” pricing model, which gives users free access to rating results, CRAs currently do not take stock in complementing issuers' profiles with more comprehensive ESG information. Material ESG risks are incorporated in the overall rating analysis and thus only reflect a detail of an issuer's ESG profile from a credit rating perspective. Consequently, CRAs do not provide stand-alone ESG assessments or an holistic overview of an entity's long-term ESG potential. Moreover, the final rating score does not necessarily reflect the impact of ESG considerations because even in instances where ESG risks have material implications, the credit impact may be mitigated by other factors like financial strength. *[Moody's, p. 7]*

Despite the incorporation of ESG factors in their rating methodologies and their potential to evolve into an integrated rating provider, the leading CRAs at this stage do not disclose any specific ESG-related information in the rating profiles published on their websites. The research, analysis and rating of ESG-specific information remains the expertise and core business of traditional ESG rating firms, who need to adapt their services to support asset managers in their mandate to conduct a more active SRI approach like ESG integration or engagement.

3. Conclusions

This research paper identified some of the factors that affect the significance and market potential of ESG ratings. It outlined a number of factors that impede ESG ratings from developing full market potential, confining them to be a non-binding indicator rather than a conventional resource for SRI portfolio management. One of the reasons is the proliferation of the ESG rating market and techniques, which is partly due to the absence of common standards and the strategic interest of ESG rating providers in conserving proprietary rating methodologies to protect a competitive edge.

Despite considerable progress of self-regulating programs to promote common frameworks and standards for ESG reporting (GRI, IIRC), accounting (SASB), research and rating (ARISTA, GISR) or SRI (PRI, BS ISO 22222[20]), these initiatives are of voluntary nature, which leaves asset

20 BS ISO 22222:2005 is an international quality standard for personal financial planners serviced by

managers free to decide on how to execute their SRI strategies. Due to the confidential nature of investment strategies it remains difficult to assess to which extent asset managers implement ESG factors in their actual business practice to meet customers' mandate.

Another critical parameter is the validity and assurance of ESG information. Even though the volume of publicly available ESG data is constantly rising, the quality of the disclosed information is depending on the issuer – such as a company - and the validation by an assessor, such as an ESG research firm. Due to a limitation of legally binding rules, ESG disclosure does not necessarily feature materiality aspects or predictive data, and thus bears the risk of being incomplete, inconsistent and difficult to compare between different industries, markets, and rating schemes. To compensate for this deficit, it would require an active investigation approach, which ESG research providers, analysts and asset managers due to constraints of resources can only perform to a limited extent.

At the same time, the significance of the sustainability information market is favorably impacted by the SRI market's own momentum and the trend towards ESG integration and active stewardship in particular. While larger financial services companies usually have sufficient resources to perform proper ESG research and analysis, the actual challenge is more for asset managers at smaller investment firms, as they need to develop skills to build and manage SRI portfolios more effectively to meet their mandate. ESG rating scores for them constitute a complementary resource for stock-picking exercises and portfolio management.

From this perspective, the demand for ESG rating services is rather driven by proper market dynamics than by external regulation. This is indicated by an ongoing market consolidation, the creation of strategic alliances, and the launch of ESG-specific products by established financial players like stock-exchanges, index providers, mutual funds, and CRAs. If the latter were to disclose comprehensive information of material ESG criteria in a more detailed way, asset managers would have a simple but reliable rating resource to draw on when managing SRI portfolios. However, as CRAs focus on material risk factors only, asset managers need to perform proper research or draw on external service providers to have these insights available to perform an active stewardship approach. This mandate necessitates direct company engagement, which represents a major endeavor for analysts, asset manager and external ESG rating providers alike.

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External ESG rating agencies try to meet his challenge by building capacity through mergers, acquisitions and partnerships. Recent developments indicate that the increasing demand from SRI professionals for transparent, reliable and material ESG ranking information is likely to be accommodated by inherent market dynamics flanked by self-regulation. The latter will be essential to assure common quality standards in regards to the transparency and reliability of rankings. Standardised ESG scores in combination with research and quality standards would finally make sustainability data sufficiently comparable, consistent, and reliable for SRI decision making, which - ultimately - might lead to a substantial expansion of the ESG ratings market well beyond its current level.

At longer-term, ESG rating scores will only be accepted by the market if the level of validity and transparency of the underlying data and applied rating methodology are adequate to meet the standards of fiduciary duty. As long as they are not fully transparent, comparable, and based on material, industry-specific, and reliable data, ESG ratings will remain of limited relevance for SRI decision-making, as they cannot provide asset managers the reliable resource they would need to meet investors' demand for more active SRI management.

Annex

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