ESG Rating Agencies in the Regulatory Cross Hairs

Paul Smith* Kubra Koldemir** Andrea Webster# Ayse Kasikci##

Executive Summary

- ESG data and service providers make up a key component in the investment allocation process. The soundness of these services is essential to satisfy investors' need for ESG data and analyses.
- While greater transparency as to the source of the ESG data is necessary due to diversity of methodologies, a regulatory framework is also required to reduce the misallocation of investments due to greenwashing.
- Unlike credit ratings, ESG measurement is somewhat slippery due to the lack of common definitions, reporting standards, and to a common understanding of the ESG impact of any one business activity (especially true in the green energy world).
- ESG scores could vary depending on what metrics are incorporated, how the elements are weighted, the qualitative judgment of the analysts, and how the metric is expressed in company disclosures. The heterogeneity in ESG scores can and do lead to distinctly different ESG portfolios.
- India is one of first countries where its capital market regulatory agency, Securities and Exchange Board of India (SEBI), has stepped up and issued a consultation paper on January 24th, 2022 to discuss with the industry how to go about regulating the ESG rating agencies.
- Rating agencies will play a key role in this growth of funds invested in ESG strategies. Thus, regulation of these agencies is inevitable. Effective regulation will need to await the standardisation of data and definitions. Until then, regulators should try to focus on developing a globally agreed approach that ensures full disclosure of conflicts of interest, calculation methodologies and judgments made.

*Founder, SustainFinance and Former President, CFA Institute
**Founder, SustainFinance and Sustainability Researcher, Arguden Governance Academy
#Financial System Transformation Lead, World Benchmarking Alliance and Senior Advisor, Sustain Finance
##Research Associate, Sustain Finance
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I. Introduction

One subject you can get rare agreement on in the world of ESG is the inconsistency in results and power wielded by ESG rating agencies. This has not gone unnoticed by the regulators as one of the potential enablers of greenwashing.

ESG data and service providers make up a key component in the investment allocation process. To satisfy investors' needs for ESG data and analysis, the soundness of these services is essential. While their influence is growing, these providers remain more or less unregulated.

Given the diversity of methodologies used for ESG ratings, greater transparency as to the source of data is necessary. A regulatory framework is also required to reduce the misallocation of investments due to greenwashing.

India is one of first countries where its capital market regulatory agency, Securities and Exchange Board of India (SEBI), has stepped up and issued a consultation paper published January 24th of this year to discuss with the industry how to go about regulating the ESG rating agencies. They argue that there is an "imperative need" to ensure that ESG ratings providers operate in a transparent and regulated environment, to reduce the risks in the market. According to the paper, ESG rating agencies will need to apply for SEBI's recognition every two years. In case any non-compliances are found, the regulator can intervene at any time.

The capital market regulator's paper has relied on the International Organization of Securities Commissions' (IOSCO) report on ESG ratings published in November 2021. IOSCO has encouraged regulators to give greater attention to the use of ESG ratings as they have so far played an important role in the growth of the ESG ecosystem. IOSCO also pointed out that this largely unregulated ratings business is already worth around $1 billion per annum and is growing at 20% a year.

In recent months, regulators from the US and Europe have been considering similar action; for instance, the UK government began to consider bringing ESG ratings providers under the Financial Conduct Authority in 2021. In January 2022 the European Securities and Markets Authority (ESMA) wrote to the European Commission supporting industry calls for regulations to be implemented for European ESG ratings agencies. The letter suggested that due to a current lack of regulation, rating agencies are not open enough about costs and methodologies, making comparability all the more demanding. This was followed up with a "Call for Evidence" on ESG ratings in February by ESMA. The purpose of this "Call" being to develop a picture of the size, structure, resourcing, revenues and product offerings of the different ESG rating providers operating in the EU.

II. Differing methodologies – The devil is in the detail

Unlike credit ratings, ESG measurement is somewhat slippery due to the lack of common definitions, reporting standards, and to a common understanding of the ESG impact of any one business activity (especially true in the green energy world). CFA Institute has provided a table with key ESG issues that an efficient rating analysis should cover.

Environmental	Social	Governance
Conservation of the natural world	*Consideration of people & relationships*	*Standards for running a company*
-Climate change and carbon emission	-Customer satisfaction	-Board composition
-Air and water pollution	-Data protection and privacy	-Audit committee structure
-Biodiversity	-Gender and diversity	-Bribery and corruption
-Deforestation	-Employee engagement	-Executive compensation
-Energy efficiency	-Community relations	-Lobbying
-Waste management	-Human rights	-Political contributions
-Water scarcity	-Labour standards	-Whistle-blower schemes

The report “Assessing corporate responsibility through ratings: Challenges and their Causes” identifies six reasons that hinder a transparent and objective rating: lack of standardization, lack of reliability of information, bias, trade-offs, lack of transparency, and lack of independence.

The divergence in methodology of primary rating agencies is well-documented; “Inside the ESG ratings: (Dis)agreement and Performance” identifies that Bloomberg and SS-Oekom emphasise on direct engagement with companies, while Thomson Reuters also studies stock market information. RobecoSAM, on the other hand, summons the world's largest listed companies to contribute in a survey, and then detects missing information together with an analysis of the information provided.

In addition, the number of indicators estimated diverges by rating agency. MSCI and FTSE Russell signify the extremes of the distribution as they evaluate 37 and 300 ESG criteria respectively. Other agencies evaluate different metrics that are industry specific for each corporation. This process is used by Sustainalytics and RobecoSAM amongst others.

Furthermore, there are also significant structural disparities. For instance, ECPI Group, an Italian rating agency, incorporates social dimensions into the governance assessment. However, RobecoSAM looks at corporate governance through an economic lens.

As a result, the difficulty in obtaining a clear definition of ESG materiality, overlaid with the consequent weighting mechanisms, creates further deviation in the range of ratings produced across the agencies for any one company. No wonder the investing public is confused!

A research paper called “Aggregate Confusion: The Divergence of ESG Ratings” studies the differences in environmental, social and governance (ESG) ratings of five providers. It splits the ratings into three bases and finds that different scopes of ESG ratings across providers unsurprisingly results in a large difference in more than 50% of the observed outcomes. This assessment validates concerns about the meaning and comparability of current ESG scores.

A review of publicly available approaches and data use from Bloomberg, Thomson Reuters, Sustainalytics, and MSCI clarifies a number of factors that may contribute to differences in ratings.

These include: framework, factor categories, subcategory metrics, measurement of arguments, judgment and indicator weights. In addition, such choices may affect the alignment of ratings with materiality, which may also explain why indices based one provider’s ratings outperform others.

Results will also be affected by those rating firms who view unaccounted for externalities (eg pollution) as financially significant relative to the costs of the risk management of known climate risks (E.g., risk management of firm assets to protect against the effects of climate change).

As a result, heterogeneity in ESG scores can and do lead to distinctly different ESG portfolios. Many companies that are ranked highly by one provider are rated much lower by others. It depends on what metrics are incorporated, how the elements are weighted, the qualitative judgment of the analysts, and how the metric is expressed in company disclosures.

III. Ambiguity or nuance in ESG?

Given the differences in approach and the lack of agreement on taxonomy, definitions and impact, how should regulators go about regulating? Indeed, can regulators regulate effectively when so many grey areas exist that are not going to be resolved any time soon? Should they be trying to regulate at all? What is regulation trying to achieve?

Normally regulators try to achieve some form of standardisation of market approach. However, how will this be achievable given that the correlation between ESG ratings for corporate equity across different providers is only around 0.3. This compares with the credit ratings industry where the correlation between ratings by S&P and Moody’s is around 0.99.

The ESG world is new. Some argue that its inherent ambiguity makes it impossible to pursue ESG investments. From an ESG perspective, everything in our world has both positive and negative outputs. Nothing is cut and dried. Unsurprisingly, the world of ESG ratings, ESG taxonomies and ESG reporting is similarly open to interpretation. Therefore, searching for certainty and for definition may be a fool's errand. What we really need is transparency and measurement. But is measurement possible?

Scoring is obviously part of the current business models of ESG ratings agencies. In theory, there should have been many benefits to investors in gaining access to comparative scores for the large number of corporations that exist within the investment universe. However, the scoring process requires extrapolation and interpretation, and this inevitably results in bias. This intensifies the ambiguity problem of ESG data and further confuses the picture.

IV. ESG rating Agencies' impact on asset allocation

While making evaluations, ESG rating companies often use algorithms that convert qualitative information into numerical data, and they may not give equal weight to each metric.

ESG rating systems, tend to diverge a lot from each other in various factors, including the number of companies covered, scope, rating system, research methodology, etc. Below is a table showing some information on three mainstream rating agencies.

	Capacity	Scope	Rating/Scoring System	Research	Benefits Provided
Sustainalytics	Over 14.000 companies	The pillars for building blocks: corporate governance, MEIs (Material ESG issues) and idiosyncratic issues (black swans)	ESG Risk Ratings are categorized across five risk levels: negligible, low, medium, high, and severe.	The ESG Risk Ratings are underpinned by more than 350 indicators (depending on the sub-industry) and 1,300 datapoints. This covers 20 material ESG issues, with detailed information on 138 sub-industries.	Due to the consistency of data in the rating reports, it has a positive reputation in ESG analysis.
MSCI	Over 8500 companies	They rate ESG issues across equity and fixed income securities, loans, mutual funds, ETFs and countries.	ESG Ratings range from leader (AAA, AA), average (A, BBB, BB) to laggard (B, CCC).	They rate over 8,500 companies (14,000 issuers including subsidiaries) and more than 680,000 equity and fixed income securities globally (as of October 2020) collecting thousands of data points for each company.	They are recognized as a "Gold Standard" data provider and voted 'Best Firm for SRI research' and 'Best Firm for Corporate Governance research' for the last four years.
S&P Global	Over 11.500 companies	Each company's ESG profile component is rated based on sector and region in which it operates. The sector/region score determines the attainable score range, and the entity specific analysis determines the entity's final score within that range.	100 points system is used.	The ESG scores are calculate based on S&P's ESG questionnaire presented to companies covered and/or publicly available data. This ESG questionnaire has over 450 questions. The methodology has two sections. The first section describes ESG credit factors and how they capture them in the credit ratings through the application of criteria. The second section describes general principles related to ESG credit factors.	ESG ratings are based on unique approach of using alternative data sources and AI technology. These technologies help them verify unstructured data.

Given the role and large influence of the ESG rating agencies, they do end up having an impact on global asset allocation, influencing how funds will flow and leading to allocations towards companies that score well. This process also benefits those companies who know how to finesse their activities so that they score highly.

Another key issue is that ESG rating firms at also take self-reported data from companies on their corporate social responsibility [CSR] activities, add their own information and weightings, and mix this information together to come up with an overall rating for a given company. Yet there is no proper and consistent globally enforced regulation that governs global corporations' disclosure responsibilities. Therefore, the information on sustainability reports is often incomplete, unaudited, and impossible to compare across peer groups.

Business model conflicts of interest amongst rating agencies is another cause of concern. Rating agencies can assume many different industry roles; consultant, data provider or rating agency, and can derive their income in part from both issuers and investors.

For all of these reasons, even though the financial community enthusiastically embraces environmental, social, and governance investing, some experts are increasingly sceptical that ESG scores are helpful in directing capital towards sustainable companies.

V. Blessing in disguise

There is a blessing in disguise in the ambiguity of ESG data. Confusion creates opportunity for the intelligent, diligent investor. Investment opportunities abound when there is market inefficiency. ESG premiums can be extracted by those active managers who deeply understand a company, talk to its management, and take into account its strategic context. Difficulties in valuing and understanding intangible ESG factors which are inherently hard to measure give the canny investor a comparative advantage. ESG is a human judgment business today rather than an alogorithm driven opportunity. Thus, it remains one of the few areas of modern finance where a person has an advantage over a machine.

VI. Regulatory motives

Some form of regulatory oversight is needed. The ESG investable universe is too large and the power of the rating agencies too great for regulators to be able to comfortably ignore it. Whilst India is taking the lead addressing a clear market issue, it must also act with transparency and clarity itself as to its motives for doing so. Leading the way through a global body or mechanism, given the global nature of ESG ratings, may perhaps have been the more powerful approach. However, if it sees the need for regulation as an urgent regulatory priority, their logic is sound. SEBI needs to be clear that this drive is not motivated by protectionist impulses which could weaken the resolve of Indian Companies to help set global ESG standards.

VII. What should the regulation achieve?

Regulators are seeking to set the ground rules for asset managers. They have two possible paths forward; a) pick one ratings methodology and exclude all others or, b) pick all methods and insist on full disclosure of conflicts of interest and full transparency of methodology. If method b) is adopted a further question arises. Should managers be forced to choose one provider themselves per product or can they blend ratings from many different providers? In short, does the onus fall back onto the manager to better disclose their process to investors?

There are no easy solutions. Data is poor; taxonomies are debated; there are big differences amongst providers. But ESG investing is big business and growing; currently estimated at US$35tn. Regulators need to act to stamp out greenwashing but how to do this effectively in such an immature market?

VIII. Conclusion

The dollars invested in ESG strategies are only going to grow in the foreseeable future. Rating agencies will play a key role in this growth. Thus, regulation of these agencies is inevitable. However, effective regulation will need to await the standardisation of data and definitions. Until then regulators should try to focus on developing a globally agreed approach that ensures full disclosure of conflicts of interest, calculation methodologies and judgments made. This will give Asset Managers the opportunity to differentiate product by choosing the data services that reflect their views. They too need to ensure that they adhere to the highest standards of transparency and disclosure so that the end investor is presented with clear choices and adequate information upon which to make their decisions.

Economic Policy & Research

Tirthankar Patnaik, PhD	tpatnaik@nse.co.in	+91-22-26598149
Prerna Singhvi, CFA	psinghvi@nse.co.in	+91-22-26598316
Ashiana Salian	asalian@nse.co.in	+91-22-26598163
Sparsh Chhabra	schhabra@nse.co.in	+91-22-26598163
Smriti Mehra	smehra@nse.co.in	+91-22-26598163
Anshul Tayal	atayal@nse.co.in	+91-22-26598163
Tanika Luthra	consultant_tluthra@nse.co.in	+91-11-2374 1741

About NSE CECG

Recognizing the important role that stock exchanges play in enhancing corporate governance (CG) standards, NSE has continually endeavoured to organize new initiatives relating to CG. To encourage best standards of CG among the Indian corporates and to keep them abreast of the emerging and existing issues, NSE has set up a Centre for Excellence in Corporate Governance (NSE CECG), which is an independent expert advisory body comprising eminent domain experts, academics and practitioners. The 'Quarterly Briefing' which offers an analysis of emerging CG issues, is brought out by the NSE CECG as a tool for dissemination, particularly among the Directors of the listed companies.

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