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Strategy and Sustainability

ESG Ratings & Index Providers and Future Sustainability Scenarios

ESG & Sustainability Transformation

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12/2023

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Company ESG Assessment and Rating:

In 2018, MSCI and Sustainalytics had the largest market shares in company-focused ESG ratings. Both rating agencies have grown by acquiring other ESG rating providers over the past decade. However, new entrants are still entering.

The different types of assessment include the following:

- Fundamental, including risk, business model, policies, and preparedness.
- Operational, including carbon impact, water stress, and human capital management.
- Disclosure-based assessment.
- Algorithm and news-based, including controversies (Truvalue Labs and RepRisk predominantly use this assessment, though most ratings companies use fundamental, operational, and disclosure-based.).

A few ESG ratings companies have attempted to look at the opportunities side of ESG factors as well.

As noted earlier, each provider has different methodologies and differing benefits and limitations. Consensus between the databases is limited.

Typically, a rating provider will establish a methodology to inform the rating by identifying a set of relevant ESG issues, assigning indicators to evaluate performance on those issues, and then developing a weighting and scoring process to evaluate a company.

Most establish systems whereby a certain level of performance on an issue is assigned a certain number of points or a grade. Points or grade assignments can be attached to a quantitative metric (e.g., the number of female directors or emissions reduced) or to qualitative assessments (e.g., a "high," "medium," or "low" assessment based on policies, procedures, or performance). Topics are also often assigned a given weight, establishing different levels of influence for different topics or sets of topics on the final rating.

ESG ratings are primarily based on historical company data and alternative data sources (e.g., media sources). Rating agencies try to synthesize these data to provide investors with information to inform investment decisions. Some ESG rating providers are also developing measures of "climate risk" that attempt to assess forward-looking risk informed by the Paris Agreement and by such initiatives as the Task Force on Climate-Related Financial Disclosures.

To produce a rating, a provider will typically perform the following tasks:

- Identify indicators that determine which ESG indicators are most material to the.
- Gather a set of data points for the identified indicators on the company in question from company public disclosures, survey responses, unstructured company data, or third-party data. Assess the data gathered for consistency and, on occasion, estimate any missing data points (not all rating providers estimate data points).
- Quantify qualitative data points through scoring or ranking methodologies; score or evaluate quantitative data points through scoring or ranking methodologies. Combine these data points with regard to the predetermined weighting system applied to the indicators to create either a sector-relative score for a company that assesses its performance relative to its peer group or an absolute score or both.

ESG factor identification is up to the rating provider; therefore, dispersal of opinions starts at this step, even before consideration of different weighting and scoring methodologies.

Several rating providers exist, though historically, MSCI and Sustainalytics have had some of the largest market shares in the equity rating space. Country-specific, or more bond-specific, services are also available at, for instance, the World Bank.

We are not elevating one method over another, and the methodologies have great detail and differences.

Some ESG Ratings Agencies:

Morningstar's sustainability ratings and Real Impact Tracker (RIT) are examples of ESG fund and fund manager assessments.

Morningstar's Sustainability Ratings:

As of 2021, Morningstar covered more than 20,000 mutual funds and more than 2,000 ETFs with a 1 to 5 score (the system was started in 2018). It uses company-level ratings from Sustainalytics (now part of Morningstar) to develop its fund ratings, and the headline rating is freely available. Morningstar takes a "holdings-based approach"—a weighted average of portfolio companies' ESG scores. No credit or assessment is given to managers' efforts on shareholder engagement and public advocacy or on their sophistication, culture, or investment strategy. One key critique of this approach is that holdings-based approaches ignore intentional ESG strategy and that the approach is necessarily backward-looking.

Given that the correlation of the two major rating systems (Sustainalytics and MSCI) is low and variable and that Morningstar uses only the Sustainalytics data for its calculations, there is limited comparability between the ratings and others.

Real Impact Tracker:

The RIT takes a more holistic approach, doing deep-dive due diligence on its manager assessments. Its "certified community" is publicly available, with details of the assessment undertaken.

Rather than using a "holdings-based approach," the RIT assesses:

- Culture,
- Philosophy,
- Process impact, and
- Public policy efforts.

Mercer's Point System:

Investment consultants, such as Mercer, will also rate the ESG capabilities of fund managers, which is often done at a fund strategy level. Mercer has a 4-point score, where its highest rating of ESG = 1 is given to less than 5% of investment teams.

Mercer's investment consultants might look for the following features:

- A demonstration that ESG factors are featured in investment teams' decision-making process and corporate culture.
- An effort has been made to build ESG factors into valuation metrics, using the investment team's own judgment about materiality and time frames.
- There is a long-term investment horizon and low portfolio turnover.
- Ownership policies and practices include sufficient oversight, integration with investment decision making, and transparency.

- For alternative assets, there is evidence of pursuing best practices in transparency and evaluation, with monitoring and improvement of ESG performance as relevant for portfolio companies and sectors.
- There is a demonstrated willingness to collaborate with other institutional investors to improve company, sector, or market performance.
- Commitment to ESG integration can be seen across the organization.

Source: Adapted from Mercer (2018).

The aim of these types of ESG assessors is to form a view on the ESG integration practices and processes of different fund managers and strategies so that end users, both retail and institutional, can match ESG and investment needs with funds that provide the best-fit services. These limitations include:

- Different methodologies (some focus on investment processes, others on portfolio holdings)
- Different data sources or rating providers
- The unaudited limited data sources
- The time resource to make the comparisons.
- The relatively non-transparent and noncomparable way these assessments are performed.

ESG Index Providers:

The likes of FTSE Russell and MSCI provide ESG index benchmarks. These indexes can be custom-built to an investor's preferences (typically at the institutional level) and are generally commercially available in more standard versions.

The index typically relies on rules-based criteria assessed on underlying ESG scores or metrics. These criteria then go into a formula to tilt company weightings or exclude entire companies based on ESG scores and hurdles. These scores can be sourced by other ESG service providers. For instance, Sustainalytics started providing FTSE Russell with underlying data from 2019 (and had provided Morningstar with data before this).

These indexes can be used as benchmarks for fund managers to be measured against or as model funds for investors to directly invest into in a form of beta or passive management.

These types of indexes have been developed into different ranges of "ESG ETFs." ETFs are made up of a basket of securities (stocks, bonds, and other assets).

These ETFs follow the underlying index or basket construction in a rules-based fashion. These can be thematic, namely investing only in certain sectors, or tilt weightings based on ESG scores, as described earlier. These scores can be data-based (e.g., carbon emissions) or ratings-based (e.g., on a provider's ratings) or a mix of the two. Debates continue as to how well these ETFs capture potential ESG factors.

Primary and Secondary ESG Data Sources:

Many ESG databases provide secondary ESG data or ratings. These are assessments transformed by a process of scoring or by a formula from a primary data source. Some providers (e.g., Bloomberg) will provide primary data sourced from company reports in an easier or consistent form to digest, along with a secondary rating (e.g., Bloomberg Disclosure score).

Primary data can be sourced from companies directly via surveys, direct company communication, and company reports, presentations, and public documents.

These public documents can be sourced from nonprofit organizations, such as the UN Global Compact or the GRI, as well as the companies' own websites. A primary source might be audited or not audited, but as of 2020, many ESG performance indicators are not audited (though the number has increased since 2018 and is expected to continue to increase, verification and auditing of carbon emissions being one important data point that is increasingly audited).

Alternatively, the source may be indirect, via news articles, third-party reports and analysis, or investment and consulting research.

Indirect assessment can be via a third-party source (e.g., Glassdoor for employee satisfaction data and scores, which are directly sourced from employee surveys). They could also come from government, regulatory bodies or non-governmental organization (NGO) reports into different segments of ESG.

Some of these data or assessments might be used widely between organizations. For instance, CDP carbon data are used as an input by many of the major ESG rating providers, such as FTSE Russell, MSCI, and Sustainalytics.

Secondary data sources typically involve transforming the primary ESG data in some way and creating new scores, assessments, or ratings based on these transformations. These are available from commercial organizations, both financial and nonfinancial, as well as from regulators, NGOs, and other nonprofit or charitable bodies.

Other Uses of ESG and Sustainability Systems Data:

Looking at all aspects, ESG data clearly have wide and varied uses within investment. This section presents some other techniques that can go beyond a company assessment but are useful for companies and analysts to consider.

"Big Data" Analysis of Multiple ESG Factors:

As can be seen, regarding quantitative analysis, algorithms and natural language processes are using ESG datasets to determine company quality, reputational risk, and many forward-looking aspects of business strength and valuation. These trends can also be analyzed at the industry or country level. Companies are starting to use big data analysis of various ESG factors in their strategic and operational analysis.

Resource, Supply, and Operational Risk Mitigation:

Assessment here is not only at a company level but can also be carried out at a systems or sector level. This would include assessments of supply chain risk (e.g., from forced labour or supply constraints) or policy changes (e.g., on carbon pricing or water usage).

These risks could include climate adaptation and transition risks to physical infrastructure or the location of human resources in risk areas—environmentally or politically.

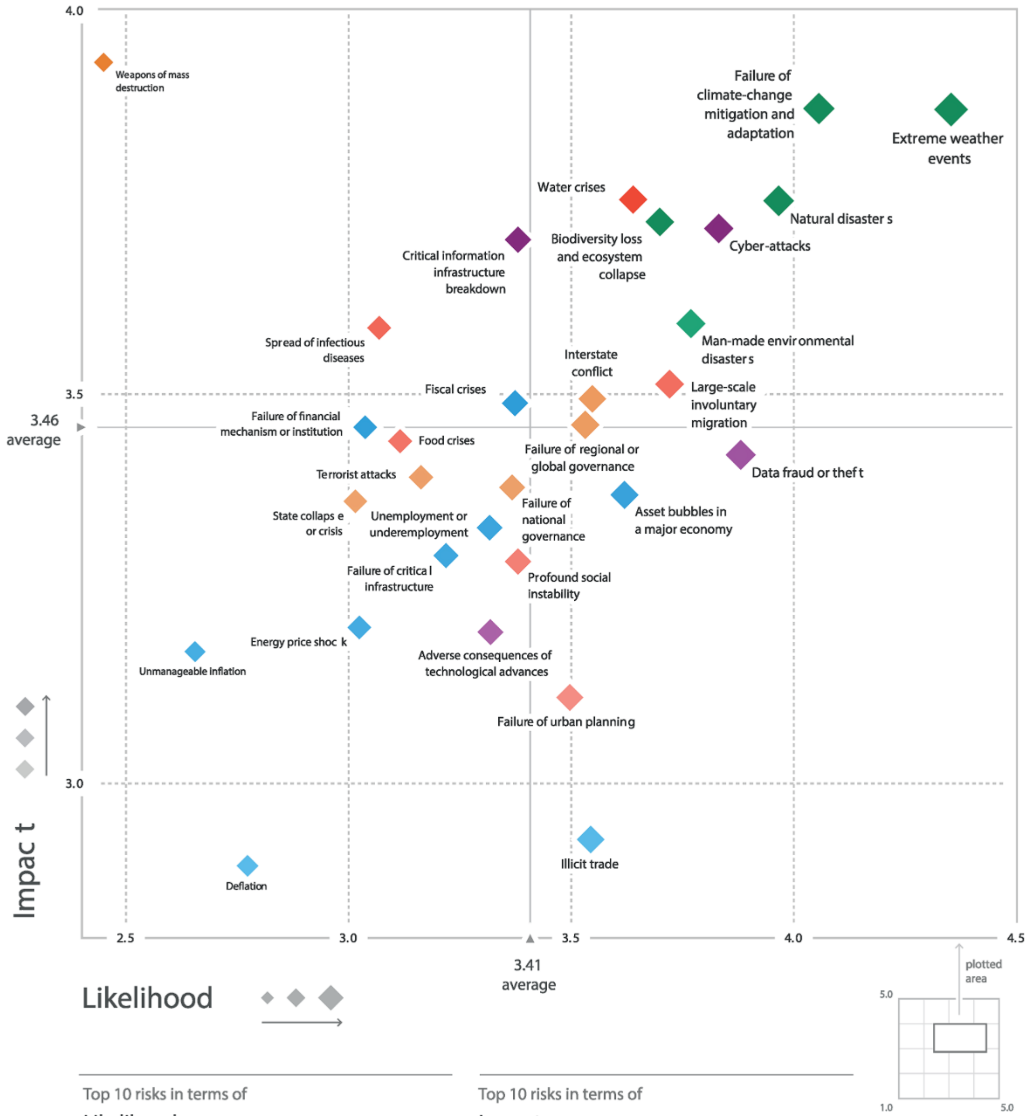
This then ties into resource-, supply-, and operations-related decision-making in terms of investments and capital allocation, where investors and companies might decide to invest further money (e.g., low-carbon technology) or withdraw further funding (e.g., thermal coal mines).

Modelling Future Sustainability Scenarios, Including Climate Change, Wage Growth, and Social Effects:

Future scenarios can be useful at the country, industry, and company level, as well as for investors. One example is climate change scenarios. One set of scenarios examines different policy interventions (e.g., levels of carbon tax). These different policy assumptions can then lead to contrasting impacts on fires and storms from varying levels of warming. These natural disasters could then affect companies (e.g., with insurers and their infrastructure) as well as countries via human migration. This type of data can be used to guide sustainability strategy and manage risk.

The World Economic Forum (WEF) shows two examples of risk mapping at this level (see Exhibit 1 and Exhibit 2). Furthermore, some would consider the analysis in Exhibit 2 a form of risk mapping.

Exhibit 1: The Global Risk Landscape 2019:



Top 10 risks in terms of
Likelihood

1. Extreme weather events
2. Failure of climate-change mitigation and adaptation
3. Natural disasters
4. Data fraud or theft
5. Cyber-attacks
6. Man-made environmental disasters
7. Large-scale involuntary migration
8. Biodiversity loss and ecosystem collapse
9. Water crises
10. Asset bubbles in a major economy

Top 10 risks in terms of
Impact

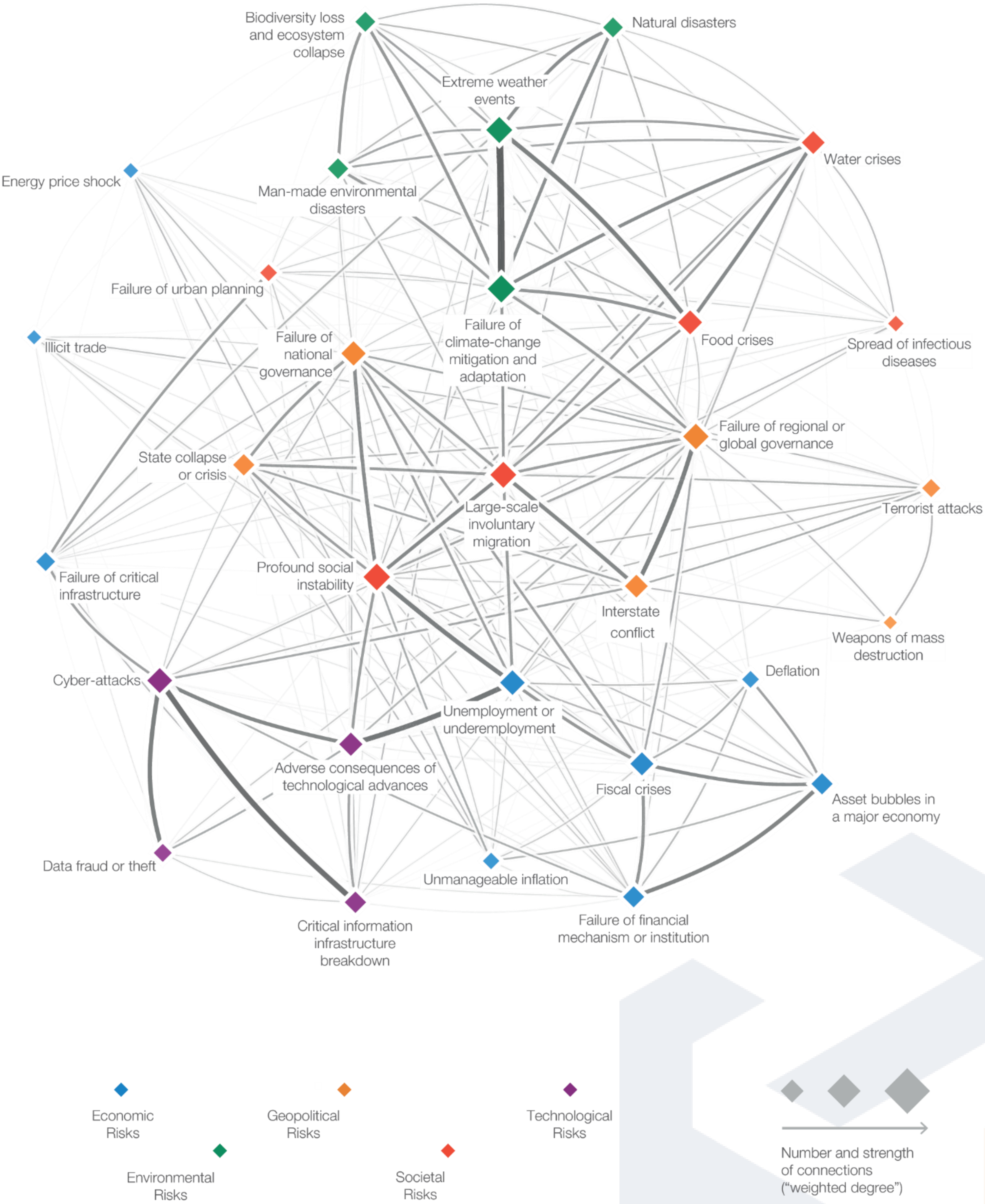
1. Weapons of mass destruction
2. Failure of climate-change mitigation and adaptation
3. Extreme weather events
4. Water crises
5. Natural disasters
6. Biodiversity loss and ecosystem collapse
7. Cyber-attacks
8. Critical information infrastructure breakdown
9. Man-made environmental disasters
10. Spread of infectious diseases

Categories

- Economic
- Environmental
- Geopolitical
- Societal
- Technological

Source: World Economic Forum (2019).

Exhibit 2: The Global Risk Interconnections Map 2019:



Source: World Economic Forum (2019).

Real-Time Dynamic Analysis:

The analysis at the frontiers of data science is being extended to real-time analysis. For instance, geospatial data are used to track deforestation, mining, construction, shipping, and traffic, and natural language processes are used to track social sentiment on the internet.

Overall, ESG investment analysis does not occur in a vacuum. The techniques and analysis are intersectional with the real world, as well as with the impact and risk on companies and countries.

To learn more about ESG and sustainability-related models, don't hesitate to contact **YTT Consulting**!