



Sustainalytics and MSCI as Major ESG Rating Providers, Their Methodology & Products

ESG & Sustainability Transformation

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ESG Transformation



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This article provides further information on Sustainalytics and its ESG products as well as MSCI Research.

It is provided to give more insight into two major rating providers' methodologies but does not suggest that these are the only ways in which ESG ratings can be performed.

Sustainalytics and Its ESG Products:

Sustainalytics is an ESG and corporate governance research and rating provider. As of 2018, it was considered a top-three provider of ESG ratings, and in 2020, it was acquired by Morningstar. It has strategic partnerships with:

- Morningstar;
- Glass Lewis (proxy adviser);
- STOXX (index provider); and
- Since 2018, FTSE Russell (index provider).

It has several products ranging from compliance and screening, index research, portfolio analysis, carbon and country risk research to ESG integration research.

The Sustainalytics' ESG Risk Rating:

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

The rating system gives points for specific risk factors. Each point of risk is equivalent, no matter which company or issue it applies to. Points will add up across issues to create overall scores, which are then rated.

The rating sorts of companies into five risk categories:

- Negligible
- Low
- Medium
- High
- Severe

These risk categories are absolute, meaning that a "high" risk assessment reflects a comparable degree of unmanaged ESG risk across the research universe, whether it refers to an agriculture company, a utility, or any other type of company.

According to Sustainalytics, an issue is considered "material" within the ESG Risk Rating if its presence or absence in financial reporting is likely to influence the decisions made by a reasonable investor.

To be considered "relevant" in the risk rating, the issue must have a potentially substantial impact on the economic value of a company and, hence, the financial risk and return profile of an investor investing in the company.



Distinguishing the ESG Risk Rating's use of materiality as a concept from narrower legal or accounting-focused definitions is important. Not every issue Sustainalytics considers "material" in the rating is legally required to be disclosed in company reporting. Some issues are "material" from an ESG perspective, even if the financial consequences are not fully measurable today.

The ESG Risk Rating's emphasis on materiality incorporates an additional dimension - the exposure dimension. It reflects the extent to which a company is exposed to material ESG risks identified at the industry level and affects the overall rating score for a company as well as its rating score for each material ESG issue. ESG issue risk exposure is estimated at the sub-industry level and further adjusted at the individual company level.

The ESG Risk Rating's second dimension is management. ESG management can be considered a set of company commitments and actions that demonstrate how a company approaches and handles an ESG issue through policies, programs, quantitative performance, and involvement in controversies, as well as its management of corporate governance. Sustainalytics considers management in the ESG Risk Rating because company commitments and actions provide signals about whether companies are managing ESG risks.

Unmanaged Risk: How Sustainalytics Arrives at the Scores

The ESG Risk Rating scoring system for a company is best thought of as occurring in three stages on the issue level:

- The starting point is exposure,
- The next stage is management, and
- The final stage is calculating unmanaged risk, using the concept of risk decomposition.

The final ESG Risk Rating score is a measure of unmanaged risk. This is defined as material ESG risk that has not been managed by a company. As noted in the subsection titled "Materiality Assessments and Risk Mapping", it includes two types of risk:

- Unmanageable risk, which cannot be addressed by company initiatives
- The management gap, which represents risks that could be managed by a company through suitable initiatives but which may not yet be managed

The share of risk that is manageable versus the share of risk that is unmanageable on a material ESG issue is predefined at a sub-industry level by a manageable risk factor. Every material ESG issue has an issue manageable risk factor (MRF), ranging from 30% (indicating that a high level of the issue risk is unmanageable) to 100% (indicating that the issue risk is considered fully manageable).

Calculating the Final Unmanaged Risk Score:

The assessment of unmanaged risk (the final ESG Risk Rating score) requires three steps:

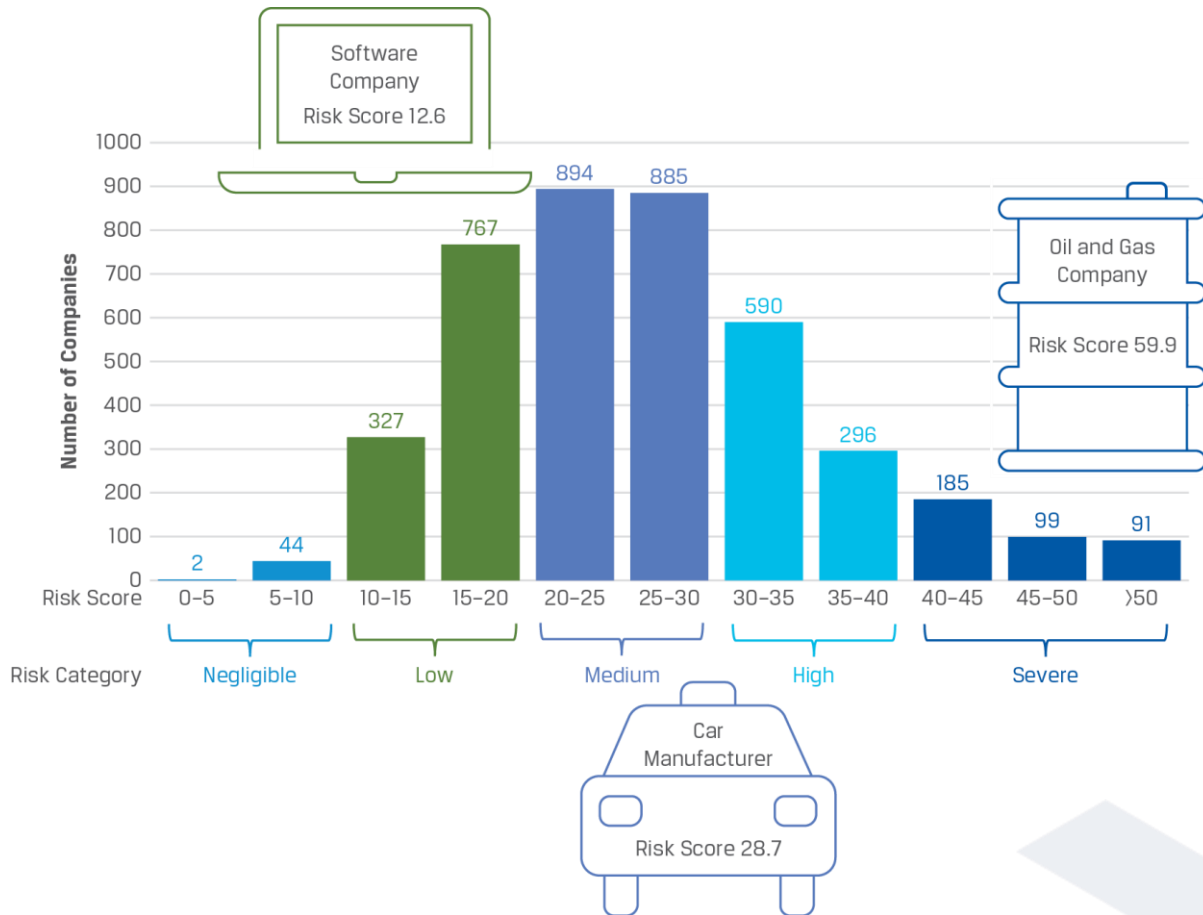
- Assess the share of the overall exposure of companies and compare to a material ESG issue in a given sub-industry that can be managed by a company (manageable risk assessment).
- At the company level, the degree to which a company has managed the manageable risk portion of its overall exposure, with regard to an issue being calculated based on the management assessment (overall management score assessment).



- Finally, the unmanaged risk score is calculated by subtracting managed risks from a company's overall exposure score in relation to a material ESG issue (final unmanaged risk score calculation).

Exhibit shows how the companies Sustainalytics has used for testing and validation are allocated across the five ESG risk categories that were defined for the ESG Risk Rating.

Exhibit: Allocation of Companies Across ESG Risk Categories (January 2020)



Source: Sustainalytics (2020).

MSCI ESG Research:

According to the MSCI ESG Rating, ESG risks and opportunities are posed by large-scale trends (e.g., climate change, resource scarcity, or demographic shifts) and the nature of the company's operations.

The MSCI considers a risk or an opportunity to be material to industry as follows:

- A risk is material to an industry when companies in a given industry are likely to incur substantial costs in connection with it (e.g., a regulatory ban on a key chemical input).
- An opportunity is material to an industry when companies in a given industry could likely capitalize on it for profit (e.g., opportunities in clean technology for the LED lighting industry).

Note that this definition of "materiality" is different from that of Sustainalytics but is still a judgment (and might differ from other investors' judgments).

MSCI assesses material risks and opportunities for each industry through a quantitative model that compares ranges and average values in each industry for externalized impacts (e.g., carbon intensity, water intensity, and injury rates). Exceptions are allowed for companies with diversified business models or that are facing controversies, or based on industry rules. Once identified, these “key issues” are assigned to each industry and company.

Exhibit summarizes the MSCI ESG hierarchy (note the overlaps with, but also differences from, the SASB mapping).

MSCI ESG Hierarchy

3 Pillars	10 Themes	37 ESG Key Issues
Environment	Climate change	Emissions
		Financing environmental impact
		Product carbon footprint
		Climate change vulnerability
	Natural resources	Water stress
		Biodiversity and land use
		Raw material sourcing
	Pollution and waste	Toxic emissions and waste
		Packaging material and waste
		Electronic waste
	Opportunities	Opportunities in clean tech
		Opportunities in green building
		Opportunities in renewable energy
Social	Human capital	Labor management
		Health and Safety
		Human capital development
		Supply chain labour standards
	Product liability	Product safety and quality
		Chemical safety
		Financial product safety
		Privacy and data security
		Responsible investment
		Health and demographic risk
	Stakeholder opposition	Controversial sourcing
	Social opportunities	Access to communications
		Access to finance
		Access to healthcare
		Opportunities in nutrition and health

3 Pillars	10 Themes	37 ESG Key Issues
Governance	Corporate governance	Board
		Pay
		Ownership
		Accounting
	Corporate behaviour	Business ethics
		Anti-competitive practices
		Tax transparency
		Corruption and instability
		Financial system instability

Source: MSCI (2019)

Final MSCI ESG Ratings are derived by the weighted averages of the key issue scores. These scores are aggregated, and companies' scores are normalized by their industries. After any overrides are factored in, each company's final industry-adjusted score corresponds to a rating between the best (AAA) and the worst (CCC). These assessments of company performance are not absolute but are explicitly intended to be relative to the standards and performance of a company's industry peers.

MSCI ESG Risk Score:

MSCI argues that to understand whether a company is adequately managing a key ESG risk, it is essential to understand both:

- What management strategies it has employed (i.e. risk management); and
- How exposed it is to the risk (i.e. risk exposure).

The MSCI ESG Ratings model attempts to measure both of these. For MSCI to score a company highly on a key issue, the management needs to be judged commensurate with the level of exposure:

- A company with high exposure must also have very strong management, but
- A company with limited exposure can have a more modest approach.

The risk exposure and management scores are combined so that a higher level of exposure requires a higher level of demonstrated management capability in order to achieve the same overall key issue score. Key issue scores are also on a 0 to 10 scale, where 0 is very poor and 10 is very good.

MSCI ESG Opportunity Score:

The assessment of MSCI ESG opportunities works similarly to risks, but the model for combining exposure and management differs:

- Exposure indicates the relevance of the opportunity to a given company based on its current business and geographic segments, and
- Management indicates the company's capacity to take advantage of the opportunity.

Where exposure is limited, the key issue score is constrained toward the middle of the 0 to 10 range, while high exposure allows for both higher and lower scores.

MSCI Controversy Assessment:



MSCI ESG Ratings also reviews controversies, which may indicate structural problems with a company's risk-management capabilities.

A controversy case is defined as an instance, or ongoing situation, in which company operations or products allegedly have a negative environmental, social or governance impact.

EXAMPLE

Controversy Cases:

The ESG rating model is applied to two controversy cases:

- A case that is deemed by an analyst to indicate structural problems
- A case that is deemed to be an indicator of recent performance, but that does not offer clear signals of future material risk.

The rating system finds that Case 1 poses future material risks for the company and therefore triggers a larger deduction from the key issue score than Case 2.

MSCI Data Sources:

These data sources that MSCI ESG Ratings use are similar to what Sustainalytics and other in-house teams might use, including the following:

- Macro data at the segment or geographic level from academic, government, and NGO datasets
- Company disclosure (e.g., annual report filings, sustainability report, proxy report, or annual general meeting results)

MSCI Final Letter Rating Summary:

To arrive at a final letter rating, the weighted average key issue score is normalized by industry. The range of scores for each industry is established annually by taking a rolling three-year average of the top and bottom scores among the MSCI ACWI Index constituents; the values are set at the 97.5th and 2.5th percentile.

Using these ranges, the weighted average key issue score is converted to an industry-adjusted score from 0 to 10, where 0 is worst and 10 is best. The industry-adjusted score corresponds to a rating between best (AAA) and worst (CCC).

MSCI ESG Research:

MSCI is historically most well-known for its market index products, but it also provides ESG and corporate governance research and ratings, a index and fund research.

As of 2018, it was considered a top-three provider of ESG ratings. Like Sustainalytics, it has several products ranging from compliance and screening, index research, portfolio analysis, and carbon risk research to ESG integration research.

MSCI has the intellectual property from legacy companies KLD, Innovest, IRRC, and GMI (Governance Metrics International) Ratings.

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

