



# Major ESG Rating Agencies Sustainalytics and MSCI, Its Methodologies and Products

ESG & Sustainability Transformation



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This article by YTT Consulting, will provide more information about Sustainalytics and its ESG products as well as MSCI Research.

The purpose is to provide more insight into the methodologies of the two major rating providers but we do not suggest that these are the only ways that ESG ratings can be done.

### **Sustainalytics and Its ESG Products:**

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

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

Sustainalytics has a number of different products, ranging from compliance and screening, index research, portfolio analysis, carbon risk and country risk research to integrated ESG research.

### **Sustainalytics ESG Risk Rating:**

The Sustainalytics ESG Risk Rating measures the extent to which a company's economic value is at risk due to ESG factors, or more technically, the company's level of unmanaged ESG risk.

The rating system assigns points to specific risk factors. Each risk score is equivalent, regardless of the company or issue it applies to. The points are added up across issues to create an overall score, which is then ranked.

The ranking of companies into five risk categories:

- Insignificant
- Low
- Medium
- High
- Severe



These risk categories are absolute, meaning that a “high” risk rating reflects the same level of unmanaged ESG risk across the entire study, whether it refers to an agricultural company, a utility company, or any other type of company.

According to Sustainalytics, a matter is considered “material” in the ESG Risk Rating if its presence or absence in the financial statements could influence the decision of a reasonable investor.

To be considered “relevant” in the risk rating, the matter must have a significant impact on the economic value of a company and therefore on the financial risk profile and return to investors investing in the company.

It is important to distinguish the use of ESG Risk Rating materiality as a concept from the narrower legal or accounting-focused definitions. Not every matter that Sustainalytics considers “material” in the rating is legally required to be disclosed in a company’s reports. Some matters are “material” from an ESG perspective, even if the financial consequences are not fully measurable today.

The ESG Risk Rating emphasizes materiality combined with an additional dimension – the risk dimension. It reflects the extent to which a company is exposed to material ESG risks identified at the industry level and affects a company’s overall rating as well as its rating for each material ESG issue. The level of risk due to ESG issues is estimated at the sub-industry level and further adjusted at the individual company level.

The second dimension of the ESG Risk Rating is governance. ESG governance can be considered a set of corporate commitments and actions that demonstrate how a company approaches and addresses ESG issues through policies, programs, quantitative performance, and engagement in corporate governance issues and management. Sustainalytics considers governance in its ESG Risk Rating because corporate commitments and actions provide signals about whether companies are managing ESG risks.

### **Unmanaged Risk: How Sustainalytics Scores It**

The ESG risk scoring system for a company is best thought of as occurring in three stages at 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 score is a measure of unmanaged risk. This is defined as material ESG risks that have not been managed by the company. It includes two types of risks:

- Unmanageable risks, which cannot be addressed by the company's own initiatives
- Management gaps, which represent risks that the company can manage through appropriate initiatives but may not yet be managed.

The ratio of manageable risk to unmanageable risk for a material ESG issue is pre-determined at the sub-sector level by a manageable risk factor. Every material ESG issue has a manageable risk factor (MRF), ranging from 30% (indicating a high risk of the issue being unmanageable) to 100% (indicating the issue risk is considered fully manageable).



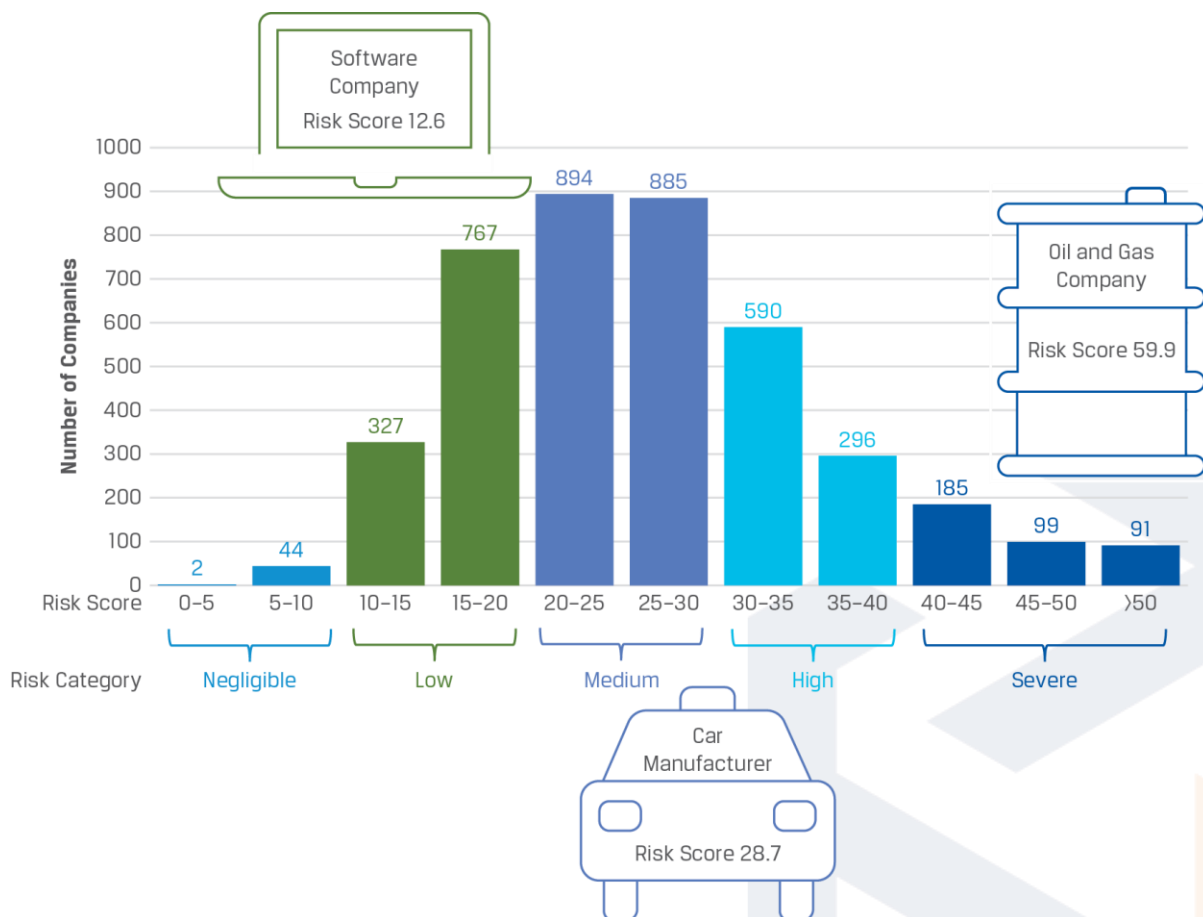
### Final Unmanaged Risk Score:

Assessing unmanaged risks (the final ESG Risk Rating) requires three steps:

- Assessing the overall risk exposure of companies and comparing it to the material ESG issues in a given sub-sector that the company can manage (assessment of manageable risks).
- At the company level, the extent to which a company has managed the manageable portion of its total risk exposure, related to an issue, is calculated based on management's assessment (assessment of overall management score).
- Finally, the unmanaged risk score is calculated by subtracting the managed risks from the company's overall risk score related to the material ESG issue (calculation of final unmanaged risk score).

The figure shows how the companies Sustainalytics uses for testing and validation are distributed across the five ESG risk categories identified for the ESG Risk Rating.

### Allocation of Companies by ESG Risk Categories (January 2020)



Source: Sustainalytics (2020).

### MSCI ESG Research:

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

MSCI considers risks or opportunities to be material to an industry as follows:

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

Note that this definition of “materiality” is different from that of Sustainalytics but is still a judgment (and may differ from the judgments of other investors).

MSCI assesses the key risks and opportunities for each sector through a quantitative model that compares the range and average values within each sector for external impacts (e.g. carbon intensity, water intensity, and occupational accident rates). Exceptions are allowed for companies with diverse or controversial business models or based on industry norms. Once identified, these “key issues” are considered for each sector and company.

A summary of MSCI’s ESG hierarchy (note the overlaps but also differences with SASB mapping).

**MSCI ESG Hierarchy:**

<b>3 Pillars</b>	<b>10 Topics</b>	<b>37 Problems of ESG</b>
Environment	Climate Change	Emissions
		Environmental Impact Financing
		Product Carbon Emissions
		Climate Change Vulnerability
	Natural Resources	Water Stress
		Biodiversity and Land Use
		Raw Material Supply
	Pollution and Waste	Waste and Hazardous Emissions
		Packaging Materials and Waste
		Wasted Electricity
	Opportunities	Opportunities in Clean Technology
		Opportunities in Green Buildings
Opportunities in Renewable Energy		
Social	Human Resources	Labour management
		Health & Safety
		Human Capital Development
		Supply Chain Labour Standards

3 Pillars	10 Topics	37 Problems of ESG
	Product Liability	Product Safety and Quality
		Chemical Safety
		Financial Product Safety
		Privacy and Data Security
		Responsible Investing
		Health and Demographic Risks
	Stakeholder Opposition	Controversial Supply
	Social Opportunities	Access to Media
		Access to Finance
		Access to Health Care
Nutrition and Medical Opportunities		
Governance	Corporate Governance	Board of Directors
		Salary
		Ownership
		Accounting
	Corporate Behaviour	Business Ethics
		Anticompetitive Practices
		Tax Transparency
		Corruption and Instability
		Financial System Instability

Source: MSCI (2019)

The final MSCI ESG rating is calculated as a weighted average of the key issue scores. These scores are aggregated, and companies' scores are normalized by their industry. After accounting for any duplicate information, each company's final industry-adjusted score corresponds to a rating between the best (AAA) and worst (CCC). These assessments of a company's performance are not absolute, but are intended to be relative to the standards and performance of companies in the same industry.

#### MSCI ESG Risk Score:

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

- What management strategies the company has employed (i.e. risk management); and



- The level of risk exposure (i.e. risk exposure). MSCI's ESG rating model attempts to measure both of these. For MSCI to rate a company highly on a material issue, its management needs to be rated commensurate with its level of risk:
- A company with high risk exposure must also have very strong management, but
- A company with limited exposure may have a more modest approach.

The risk exposure and management scores are combined so that higher risk exposures require a higher level of demonstrated management capability to achieve the same key issue score. The main issues are also scored on a scale of 0 to 10, where 0 is very poor and 10 is very good.

### **MSCI ESG Opportunity Score:**

MSCI ESG opportunity assessments are performed similarly to risk, but the risk and management integration model is different:

- Exposure indicates the relevance of the opportunities to a given company, based on its current business segments and geographies, and
- Management indicates the company's ability to capitalize on the opportunities.

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

### **Controversy Assessment of MSCI:**

MSCI ESG ratings also consider controversies, which can indicate structural problems with a company's ability to manage risk. A controversy is defined as an ongoing case or situation in which a company's operations or products are alleged to have a negative environmental, social or governance impact.

### **EXAMPLE**

#### **Controversial Cases:**

The ESG rating model is applied to two controversial cases:

- One case is considered by an analyst to indicate structural issues
- One case is considered to be an indicator of recent performance but does not provide a clear signal of material future risk.

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

#### **MSCI Data Sources:**

The data sources that MSCI ESG Ratings uses are similar to those that Sustainalytics and other internal teams may use, including:

- Macro data at the segment or geographic level from academic research datasets, government and NGO sources
- Company disclosures (e.g., annual reporting filings, sustainability reports, proxy statements or annual shareholder meeting results)

#### **MSCI Final Letter Rating Summary:**



To arrive at the final letter rating, the weighted major issue averages are standardized by industry. The score ranges for each industry are established annually by taking the three-year rolling average of the highest and lowest scores among the MSCI ACWI Index components; values are set at the 97.5th and 2.5th percentiles.

Using these ranges, the weighted major issue averages are converted to industry-adjusted scores ranging from 0 to 10, with 0 being the worst and 10 being the best. The industry-adjusted scores correspond to ratings between the best (AAA) and the worst (CCC).

### **MSCI ESG Research:**

Historically, MSCI is best known for its market index products, but it also offers ESG and corporate governance research, ratings, index and fund research.

As of 2018, MSCI is considered a leading provider of ESG ratings. Like Sustainalytics, it has a number of products ranging from compliance and screening, index research, portfolio analysis and carbon risk research to integrated ESG research.

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

To learn more about ESG and sustainability-related models, please contact: [YTT Consulting!](#)

