The Role of ESG Ratings Providers in Assessing ESG Performance and Risks

As Environmental, Social and Governance (ESG) performance becomes more prominent, institutional investors, asset managers, financial institutions, and other stakeholders are increasingly looking at ESG factors in making investment and lending decisions. In doing so, these entities are relying on a number of information sources, including ESG ratings and reports.

ESG ratings are designed to measure and assess a company's long term exposure to ESG risks and its performance in managing those risks relative to industry peers. Although several providers have emerged in this area, there is no specific standard or industry guideline for establishing an ESG rating. Rather, methodology, scope, and coverage vary greatly amongst ratings providers with each provider applying its own set of criteria to the evaluation process. Because each ratings provider has its own specific approach to measuring a company's ESG exposure and performance, ESG scores for the same company can vary widely.

Companies that measure and rate ESG performance include but are not limited to: (i) Bloomberg ESG Data Services; (ii) Dow Jones Sustainability Index; (iii) MSCI ESG Research; (iv) Sustainalytics; (v) Thomson Reuters ESG Research Data; (vi) S&P Global; (v) ISS ESG; (vi) Vigeo/EIRIS; (vi) Fitch Ratings; and (vii) Moody's Investors Service. Each of these companies has established criteria for measuring ESG performance based on the aggregation of numerous data points from various places such as securities filings, voluntary disclosures (including on company websites), governmental databases, academic information, and media sources. A significant source of data for most ratings providers is data published by non-governmental organizations (NGOs) that collect ESG data from participating companies such as the global reporting initiative, the Sustainability Accounting Standards Board (SASB), the Carbon Disclosure Project, and the UN Sustainable Development Goals.

For example, MSCI ESG ratings focus on a company's exposure to financially relevant ESG risks and rank potential investments on a letter scale from AAA ("leaders" on ESG) to CCC (what MSCI calls "laggards"). MSCI ESG ratings evaluate each of the environmental, social, and corporate governance factors separately focusing on key issues. For environmental, these key issues include contribution to climate change, utilization of "natural capital" (such as raw materials sourcing), pollution, waste management, and a company's use of green technologies and renewable energy. For social, key issues include health and safety, consumer safety, community relations, and social opportunities. For governance, MSCI ESG ratings emphasize corporate fairness, accountability, transparency, and ethics. Within each of these categories, MSCI scores a company on each key issue from zero to ten and incorporates exposure to controversial business activities (such as tobacco and weapons) into the process. Scores are ultimately aggregated, weighted, and scaled to the relevant industry sector to arrive at an overall ESG rating.

Another established ESG ratings provider, Sustainalytics, measures a company's exposure to industry-specific material ESG risks and evaluates how well a rated company is managing those risks. Sustainalytics categorizes ESG risks into five categories, ranging from "negligible" to "severe" based on a quantitive score. Under its scoring approach, the final risk category can be applied across multiple industries such that ESG performance for a company in one industry can be compared against the ESG performance of a company in an entirely different industry. S&P Global's ESG rating, on the other hand, utilizes a proprietary company-specific assessment based on questions answered by the corporation, combines those responses with publicly available data points, and then categorizes and weighs the data points to come up with a score that is based on financial materiality for each industry. S&P Global looks at a company's exposure to observable ESG risks and evaluates the company's preparedness for, and ability to adapt to, a variety of long-term plausible disruptions. S&P Global then rates ESG performance by applying a numeric score ranging from 0 to 100.

Although ESG ratings firms provide important information when evaluating a company's ESG opportunities and risks, these ratings are not substitutes for due diligence nor are they an absolute measure of credit risk. That said, there can be a correlation between higher credit quality and the inclusion of ESG factors in a company's goals and practices.

In fact, all of the major credit ratings agencies, including Fitch, S&P, and Moody's, factored ESG criteria into their credit ratings process long before the development of their ESG rating products. According to these agencies, they continue to analyze ESG criteria separate and apart from their ESG rating products with a focus on ESG criteria that can have a material negative or positive impact on credit worthiness. For example, when an ESG criteria impacts credit quality, it is outlined explicitly and transparently in S&P's publicly available rating actions. Additionally, S&P provides timely modification of its ESG credit analysis as ESG events occur in a particular industry. S&P may even adopt internal score cards to analyze how ESG criteria impact creditworthiness. Moody's scores ESG considerations in its credit rating methodologies to be used as a reference tool in its overall credit rating process. Alternatively, Fitch applies a systematic scoring system approach to demonstrate how ESG criteria is material to its credit rating process.

While their internal ESG credit review process may differ, each of S&P, Moody's and Fitch claims to be committed to establishing a transparent and systematic integration of ESG criteria into their respective credit review process. Such commitment is evidenced by their signature to the Statement on ESG in Credit Risk and Ratings (the "Statement") facilitated by Principles for Responsible Investments (PRI), which, to date, has been signed by 23 other credit rating agencies and 170 investors. The purpose of the Statement is to illustrate each signatory's common goal to enhance the method of applying ESG criteria to the credit review process. The Statement affirms the commitment of credit rating agencies to: (1) evaluate the extent to which ESG factors are credit-relevant for different issuers; (2) publish their views transparently on the ways in which ESG factors are considered in credit ratings; (3) review the ways ESG factors are integrated into credit analysis as their understanding of these factors evolves; (4) maintain organizational governance and resourcing to deliver quality ratings, including ESG analysis where relevant; (5) participate in industry-wide efforts to develop consistent public disclosure by issuers on ESG factors that could impact their creditworthiness; and (6) participate in dialogue with investors to identify and understand ESG risks to creditworthiness.

Because different ratings agencies utilize their own methodologies and scoring systems when evaluating ESG factors with no uniform standard across the industry, it is important for any entity relying on an ESG rating to understand the methodology being utilized and what it means for their particular purpose. We can expect that as ESG issues increase in importance in investment and credit decisions, ratings providers, and the systems they use to evaluate and score ESG factors, will mature and evolve as well.

For More Information

Please contact Kristin Parker, Latrice Baptiste, the Chapman attorney with whom you regularly work, or visit our Social Finance and Impacting Investing resources at chapman.com.

Kristin L. Parker
Chicago
312.845.3481
kparker@chapman.com

Latrice M. Baptiste
New York
212.655.2551
baptiste@chapman.com

Chapman and Cutler LLP
Attorneys at Law · Focused on Finance®