What investors should know about ESG ratings

by Allan Marks

Institutional investors increasingly consider third-party environmental, social, and governance (ESG) ratings as part of their credit and risk assessment process for potential investments. Too often, these ESG ratings are misunderstood, oversimplified or misapplied as part of a check-the-box compliance exercise divorced from their real utility in assessing one or both of these key questions:

1. How is the issuer potentially exposed to ESG-related risks in ways that might not be apparent from traditional financial analysis (i.e., corporate value)?
2. Does the issuer or the particular investment meet the investor's own goals with respect to sustainability and impact on the environment, employees, local communities, suppliers and other stakeholders (i.e., corporate values)?

In most cases, ESG ratings emphasize only the risks that are material to the issuer (just the first question above), not sustainability writ large. ESG ratings evaluate the performance and risks of an infrastructure project or company based on numerous factors, such as exposure to climate risks, regulation of greenhouse gas emissions, effective and transparent governance, ethical supply chains, labor standards, and human rights practices and board diversity. The degree to which ESG ratings are a useful tool depends on the purpose of the review and the quality of the data, as well as the context of the issuer's business.

ESG ratings can be a useful tool for risk assessment, especially for risks that may impact a company's equity valuation, financial stability, and ability to meet its obligations. ESG ratings help investors to identify potential risks associated with a company's ESG performance. Companies with high ESG ratings tend to perform better in terms of financial performance and sustainability. Debate continues about whether this correlation suggests causation in some way. Nonetheless, by investing in these companies, investors might achieve better long-term returns. Thus, investors can align their investments with their values while potentially reducing their risk exposure by investing in companies with high ESG ratings.

Many institutional investors use ESG ratings for investment selection and underwriting criteria or require an issuer to have a minimum ESG rating to be eligible for investment. Standards focusing on the materiality of an issuer's business operations to others, including impacts on stakeholders broadly defined, on the climate and the environment, or on future generations, are more accurately called sustainability or stewardship concerns and not simply ESG factors. ESG ratings often conflate these two questions without as clean of a differentiation as many investors might like. Such double materiality is of increasing concern to many institutional investors (at least for gatekeeping, if not for risk assessment, pricing and valuation). It is also a consideration for issuers, their boards, and their other investors, including public equity holders, stewardship committees at large fund managers, and proxy advisers. Accordingly, ESG ratings often evaluate performance and risk by considering both external impacts from the rated company's activities and the potential impacts on the company of its internal practices and relevant external factors.

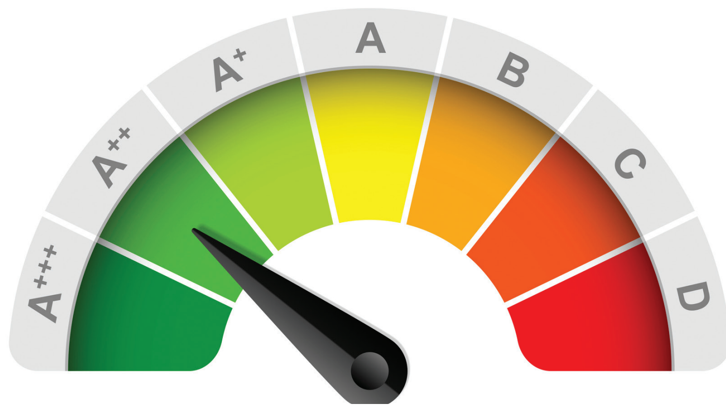
As a result, failure to track, manage and evaluate ESG-related risks has itself become a potential risk factor for many issuers and investors, alike. By avoiding or mitigating ESG risks, investors can protect their investments and, it is often claimed, avoid reputational damage. Reputational risk alone, however, can be illusory and should be better viewed as an imperative for management competence and integrity, actual risk reduction, and practical key performance indicators (KPIs) and covenant packages in debt documents.

> *"By highlighting areas where a company's ESG performance could be improved, investors can encourage companies to make changes that reduce their risk exposure and that are consistent with any stewardship requirements the investor may have."*

ESG metrics and ratings also provide a tool for engaging with issuers. By highlighting areas where a company's ESG performance could be improved, investors can encourage companies to make changes that reduce their risk exposure and that are consistent with any stewardship requirements the investor may have.

As with credit ratings and other independent yardsticks, investors relying on ESG ratings should understand the methodologies, approach, scope, and areas of focus being used to assess ESG performance and risks. A variety of organizations, including specialized rating agencies, research firms, and data providers, put out ESG ratings. MSCI provides ESG ratings and research on more than 14,000 equity and fixed income issuers worldwide, based on more than 1,000 ESG factors. Morningstar's Sustainalytics provides ESG ratings for more than 20,000 companies worldwide and publishes data on more than 40,000 companies. S&P Global, which acquired the sustainability-focused ratings business RobecoSAM in 2019, uses its annual Corporate Sustainability Assessment to create ESG ratings and research for more than 8,000 companies worldwide. Bloomberg provides ESG

data, analytics and disclosure scores using data on a range of ESG factors, including climate risk, labor practices, and corporate governance and shareholders' rights. ISS ESG, an arm of Institutional Shareholder Services Inc., provides ESG ratings for more than 8,000 companies worldwide based on more than 100 ESG factors, including climate change, labor standards and corruption. ESG ratings and sustainability scores are provided by other institutions, too, including FTSE Russell, Moody's and the non-profit Climate Disclosure Project (CDP).



ESG ratings are often based on subjective criteria, which can lead to different assessments of risk and performance. This can make it difficult for investors to make informed decisions. To ensure that ESG ratings are meaningful and relevant to investors and companies, there could be more focus on materiality and impact — that is, the ESG issues that are most likely to affect a company's long-term financial performance and (if relevant to the investor) broader societal or environmental impacts. This focus would help to prioritize ESG issues that are most relevant and important for different stakeholders or investors.

It is a challenge to reduce complex qualitative analysis to simple quantitative scores. While ESG ratings can be a useful tool for institutional investors to assess risk and performance, limitations remain, and investors should be aware of these limitations when using ESG ratings and making investment decisions. There is a significant lack of standardization between providers of ESG ratings, both as to methodology and scope. This variation often leads to inconsistent assessments of risk and performance.

Similarly, a single ESG rating can mask wide variation within a company or an investment in how the E (environmental), S (social) or G (governmental) factors are assessed. A "clean and green" company with poor labor practices might score highly on E but poorly on S or G. A well-managed company in a highly polluting industry might nonetheless excel at management transparency, diversity, workforce development, cybersecurity risk management and community relations. Does excellence in governance or social metrics offset environmental impacts of greenhouse gas emissions or exposure to potential climate regulation? These are complicated questions requiring more nuanced and rigorous analysis than most ESG ratings can provide. For this reason, many large institutional investors perform their own internal assessments of ESG factors, treating E, S and G separately, alongside traditional financial analysis and credit assessments, rather than relying solely on third-party ESG assessments and credit ratings.

In all these areas, availability and reliability of data remain significant challenges. ESG ratings mainly rely on data provided by companies, which may not always be accurate or complete. This reliance on uneven, scarce or selective data can lead to inaccurate assessments of risk and performance. Many assessments of ESG performance are subjective, making it inadvisable to rely blindly on just a few ESG ratings.

Several recent surveys of major corporations and ESG experts the challenges of ESG ratings and data deficiencies. Citing results from a 2021 survey by Diligent and OCEG to assess the current state of ESG planning and activity, the World Economic Forum called data "the No. 1 ESG challenge organizations face." The survey found that fewer than half of respondents had a formal, documented ESG program in place; under 10 percent were "highly confident" that their organization had mature, well-documented ESG capabilities; about half of all organizations surveyed do not publish ESG metrics of any kind; and just 9 percent of participants are actively using software that supports data collection, analysis and reporting on ESG.

Similarly, a 2021 survey by the Global Association of Risk Professionals (GARP) of more than 400 ESG professionals from a variety of industries found the most common challenges in using ESG research

and ratings were data quality and availability, inconsistent standards and definitions, and a lack of transparency in how ESG ratings are calculated. In 2020, the Harvard Law School Forum on Corporate Governance conducted a survey of more than 750 directors and officers of public companies. The survey found the most commonly cited challenges in implementing ESG practices were a lack of reliable data, inconsistent reporting standards and difficulty in quantifying the impact of ESG initiatives.

These surveys highlight some of the key challenges and concerns around ESG ratings and data deficiencies. They also suggest there is a need for greater collaboration and standardization in the ESG space to address these challenges and enable more effective use of ESG data and ratings.

Overall, addressing the problem of inconsistent ESG data will require increased standardization and transparency in reporting, as well as greater collaboration between companies, investors, and other stakeholders in developing more consistent ESG data collection and assessment methodologies. Inconsistent ESG data can arise from a variety of factors, including differences in reporting standards, data collection methodologies and materiality assessments. For example, some companies may report more extensively on certain ESG issues than others, or they may use different frameworks or metrics to evaluate their ESG performance. This can make it difficult for investors to make meaningful comparisons across companies or industries, and it can limit the effectiveness of ESG data in guiding investment decisions.

Too much standardization, however, may create other challenges. One size does not fit all. For infrastructure and energy investments, checking the issuer's ESG ratings (if available) is often only one step in the due diligence process. Issuers and investments should be evaluated within their specific context. Differences in technology, economic sector, geographic location, commercial relationships, and financial metrics all matter. Most ESG ratings are too generic to cover contextual variation. Many ratings tools are also too static to capture present or potential trends and forecasted changes in markets, regulations or technology preferences.

Looking at impact and not just risk — at values and not just value — ESG ratings help some investors to align their investments with their values. By investing in companies that prioritize sustainability and social responsibility, investors can support positive social and environmental outcomes. Specific investments, such as renewable power facilities, may be viewed as intentionally positive for sustainability goals; for example, with the use of funds allowing certification as green bonds or sustainable securities. Other investments may not have a restricted use of funds but are in issuers that have heightened exposure to ESG risks or changing regulation.

> *"Addressing the problem of inconsistent ESG data will require increased standardization and transparency in reporting, as well as greater collaboration between companies, investors, and other stakeholders."*

For institutional investors deploying capital on behalf of particular funds or products, it is critical to align each investment substantively with the way the fund or product is being disclosed or marketed to others — limited partners, endowment trustees, insurance policyholders, pension fiduciaries and so forth — to avoid greenwashing or potential liability from material misstatements. Some companies may prioritize their ESG ratings over their actual performance. This can lead to misleading assessments of risk and performance, which can harm investors, and lead to potential greenwashing. ESG ratings do not always measure the gap between stated intentions and actual performance, or between aspirational goals and current practices. Indeed, ratings are sometimes used selectively as tool of greenwashing. It is important to look at what is behind a rating.

In short, ESG ratings have real value when taken together with other risk assessments, targeted due diligence and credit analysis, and when aligned with the investor's goals. With improved data collection, more standardized methodologies, and better attention to the particular context in which issuers operate, ESG ratings can become more relevant to the creation and preservation of both value and values. ❖

Allan Marks is a global project, energy & infrastructure finance partner with **Milbank.**

Copyright © 2023 by Institutional Real Estate, Inc. Material may not be reproduced in whole or in part without the express written permission of the publisher.