

Navigating ESG Rating Challenges

Managing Risk with Insufficient Transparency
Congruency & Other Contradictions



ESGiQ
Powered by **MZ**TM

ESG Ratings—Definition and Impact

Environmental, social, and governance—or ESG—values are the essential pillars for measuring a company’s long-term resilience against material non-financial risks that can have substantial financial consequences.

- **E—Environmental Criteria:** The environmental element of ESG covers aspects of company energy usage, waste discharge, resource demands, carbon emissions, and climate change. Every company affects the environment and, in turn, is also being affected by the environment in which it operates.
- **S—Social Criteria:** Companies must learn to align with standards within the community they intend to grow and prosper, which involves addressing the social component of ESG. Social criteria measure the relationship between the company and its surrounding communities, which can include labor relations and diversity initiatives.
- **G—Governance Criteria:** Governance criteria measure a compilation of the internal protocols or policies a company uses to govern itself and make decisions that comply with the law, best practices, and stakeholder expectations.

Various ESG-related criteria, including measurement, scientific targets, and related policies have been adopted into rating models by various third-party rating agencies, such as Sustainalytics, ISS, MSCI, Bloomberg, S&P, and The Upright Project, with a goal to help investors determine how the company manages non-financial material risks, which are likely to have material financial consequences. In this paper we will evaluate the advantages and drawbacks of ESG ratings today, analyze correlation in methodologies and rating remuneration across providers, and assess the degree of importance external audiences place on ESG ratings.

Ideally, the benefits of a good ESG rating should include greater market acceptance, a positive impact from end-consumers, and increased confidence in sustainability of the business model, consequently resulting in a lower cost of capital. ESG-conscious brands can attract new customers from the increasing base of sustainability-focused consumers in the market. The latest data shows that 66% of consumers¹ plan to make more ethical purchases, even if they had to pay more for their “green” choices². Studies have shown that companies with strong ESG scores experience lower levels of debt³, have an easier time obtaining financing, and can decrease their cost of capital by as much as 10%⁴. ESG ratings also support sustainability-linked loans (SLLs), or green loans, which grew 292% in volume from 2020 to 2021⁵.

The Value of ESG

1. ESG ratings are in large part motivated by the values of socially responsible investors who are looking to contribute to a market worth more than \$17 trillion in sustainable assets—which equates to a whopping one-third of all managed assets⁶ globally.
2. Companies with good ESG ratings can also attract quality job applicants, which have become a hot commodity in the post-Covid-19 pandemic job market, since millennials in particular have expressed the importance of working for a socially responsible company⁷.

1) Accenture, [Shaping the Sustainable Organization](#), 2021
 2) McKinsey, [How Much Will Consumers Pay to go Green?](#), 2021
 3) MSCI, [ESG and the Cost of Capital](#), 2020
 4) McKinsey, [Why ESG is Here to Stay](#), 2020
 5) Bloomberg, [U.S. Sustainability-Linked Loans are 292% More than All of 2020](#), 2021
 6) [US SIF, Trends Report](#), 2020
 7) Forbes, [The Power of Purpose: The Business Case For Purpose](#), 2020

3. ESG investing has been on the rise over the last decade but has experienced exponential growth of 42% in recent years between 2018 and 2020⁸. It is expected that this astronomical growth of socially responsible investments (SRIs) will continue to rise: ESG-focused assets under management are expected to exceed \$50 trillion in AUM by 2025 with ESG ETFs expected to exceed \$1 trillion and, as a result, the rating system must evolve to meet the growing needs of a nebulous market.
4. There is also undeniable value in reducing waste and increasing resource efficiency across the entire supply chain spectrum. Increasing efficiency in water usage, sustainable packaging, energy usage, and efficient shipping and logistics not only decrease operating costs but also maximize carbon efficiency.
5. Following ESG guidance on a structural level reduces costly fees resulting from regulatory breaches, maximizes green incentives (in the U.S.), minimizes green taxes^{9,10} (in Canada and most EU countries), and avoids inviting unnecessary legal intervention.
6. Meticulous sustainability analysis unequivocally reduces the risk of provoking an adverse reaction from the public, investors, non-profits, lobbyists, and even governments, which usually leads to a loss in corporate profits. In fact, integrating ESG strategy, sustainability policies, and targets can garner federal and local government support through funding options, such as environmental grants and subsidies.

There is an undeniable positive correlation between increased risk management of material non-financial sustainability matters and corporate profitability. The main point of ESG ratings is to provide a point of reference to anyone voting with their dollar for a given company as to where the company stands on the “ESG Scale”, thereby streamlining research that stakeholders would otherwise need to conduct on their own. This begs a couple important questions – does a good ESG rating actually mean that a company is ESG-conscious and properly manages its non-material risks? What is a “good rating” anyway – whose standards should be followed? Prompted by these questions, the ESG rating industry is surrounded by nagging doubts among market participants questioning whether ESG Ratings are effective predictors of a company’s future financial success.

The credibility of ESG rating methodologies stands somewhere between that of equity research, which is dominated by credible, albeit very subjective, views of individual analysts, and those of credit rating agencies for debt securities, whose methodologies are standardized and highly regulated. ESG rating agencies definitely aspire to the latter but given the lack of ripeness of the current ESG regulatory climate and lack of standardization, they gravitate towards the former: each research team builds its own model, assigns targets, weightings, and ratings. Equity research analysis provides a nice reference point, but the buy side usually generates its own models and targets, opting to trust their own methodologies instead. We see a similar trend with ESG ratings.

Without downplaying the merit of the underlying research across all of the agencies we consider here, ESG ratings still have a long way to go in terms of credibility, reliability, and uniformity to become as widely accepted as those of the credit rating agencies.

8) US SIF, [Trends Report](#), 2020

9) GSAI, Bloomberg Intelligence, June 2022

10) Green taxes are a fiscal tool that force consumers to make greener choices by taxing products sourced from environmentally unfriendly sources (i.e. fossil fuels, energy from the grid, non-recyclable single-use plastic). This can be compared to the “positive reinforcement” mindset of countries like the U.S. which grant green credits, or fiscal “breaks,” for sustainable choices and initiatives.

Why are ESG Ratings Controversial?

- No standard for reporting frameworks and methodology, scope, or rating systems
- A lack of quantifiable measurement of good or bad ESG metrics
- Failure to establish a bottom-up perspective or vantage point – most ratings stem from top-down industry analysis or a generic list of boxes to be checked
- Most rating agencies do not publicly disclose their rating methodology (at least not for free), making it, at the end of the day, a pay-to-play system
- Rating agencies that do publish their methodology do not include meaningful details that can be leveraged by the company without paying to learn more
- Bad ratings require companies to work with the rating agency on retainer to improve scores and continuously purchase reports that usually occur quarterly.
- Often, agencies provide companies and their advisors with different access to reports and content, effectively precluding advisors from leveraging their advisory expertise and forcing the company to work with advisors of the rating agencies.
- To a large extent informational inputs are collected from the public domain through artificial intelligence (AI) engines, with limited overview from live advisors. A large volume of the information collected is analyzed by a computer and automatically rated by the pre-programmed model. Companies have an opportunity to make comments and speak to the analysts, but these interactions are controlled, and there is often a limit in amount of time to discuss or questions the companies can discuss.

Overview of Leading ESG Rating Agencies

ESG ratings and reports are provided by third-party agencies to assess a company's ESG performance through a combination of global ESG frameworks, industry best practices, and comparisons with industry peers. There are many ESG rating agencies, but some of the most prominent ones include:

- I. MSCI ESG Research
- II. ISS ESG
- III. Sustainalytics
- IV. S&P Global
- V. The Upright Project

MSCI ESG Ratings Model

MSCI ESG ratings are based on a comprehensive review of a company’s long-term goals for ESG investment standards and socially responsible investments (SRIs). Specifically, MSCI focuses on the degree of a company’s exposure to heightened financial risks involving ESG, meaning, how the company is being affected by environmental, social, and governance issues, but not the other way around. For example, if a company’s operations are relatively insulated from climate change aspects, the methodology does not evaluate (or penalize) the company if its operations contribute in a major way to climate change. MSCI scores rate all three components of ESG with a letter system ranging from AAA to CCC. These scores are based on an MSCI-developed hierarchy of issues that are calculated as a weighted average and are normalized relative to industry peers with an Industry-Adjusted Score (IAS). The goal is to calculate the potential costs these risks may generate in addition to highlighting possible opportunities from timely addressing ESG issues directly.

Letter Rating	Leader/Laggard	Final Industry-Adjusted Company Score
AAA	Leader	8.571* - 10.0
AA	Leader	7.143 - 8.571
A	Average	5.714 - 7.143
BBB	Average	4.286 - 5.714
BB	Average	2.857 - 4.286
B	Laggard	1.429 - 2.857
CCC	Laggard	0.0 - 1.429

Figure 1: MSCI Letter Rating Methodology, MSCI.com

		Expected Time Frame for Risk/Opportunity to Materialize	
		Short-Term (<2 years)	Long-Term (5+ years)
Level of Contribution to Environmental or Social Impact	Industry is <u>major</u> contributor to impact	Highest Weight	
	Industry is <u>minor</u> contributor to impact		Lowest Weight

Figure 2: MSCI Weighting Methodology, MSCI.com

MSCI ESG Issue Hierarchy

3 Pillars	10 Themes	35 ESG Key Issues	
Environment	Climate Change	<ul style="list-style-type: none"> Carbon Emissions Product Carbon Footprint 	<ul style="list-style-type: none"> Financing Environmental Impact Climate Change Vulnerability
	Natural Capital	<ul style="list-style-type: none"> Water Stress Biodiversity & Land Use 	<ul style="list-style-type: none"> Raw Material Sourcing
	Pollution & Waste	<ul style="list-style-type: none"> Toxic Emissions & Waste Packaging Material & Waste 	<ul style="list-style-type: none"> Electronic Waste
	Environmental Opportunities	<ul style="list-style-type: none"> Opportunities in Clean Tech Opportunities in Green Building 	<ul style="list-style-type: none"> Opportunities in Renewable Energy
Social	Human Capital	<ul style="list-style-type: none"> Labor Management Health & Safety 	<ul style="list-style-type: none"> Human Capital Development Supply Chain Labor Standards
	Product Liability	<ul style="list-style-type: none"> Product Safety & Quality Chemical Safety Consumer Financial Protection 	<ul style="list-style-type: none"> Privacy & Data Security Responsible Investment Health & Demographic Risk
	Stakeholder Opposition	<ul style="list-style-type: none"> Controversial Sourcing Community Relations 	
	Social Opportunities	<ul style="list-style-type: none"> Access to Communications Access to Finance 	<ul style="list-style-type: none"> Access to Health Care Opportunities in Nutrition & Health
Governance	Corporate Governance	<ul style="list-style-type: none"> Ownership & Control Board 	<ul style="list-style-type: none"> Pay Accounting
	Corporate Behavior	<ul style="list-style-type: none"> Business Ethics Tax Transparency 	

Figure 3: MSCI ESG Issue Hierarchy, MSCI.com

4 Key Questions Used to Determine MSCI Ratings

1. What are the most significant ESG-related risks or opportunities for the company?
2. How exposed is the company to those risks?
3. How well the company is managing those risks?
4. What is the big picture for the company compared to its industry peers around the globe?

Institutional Shareholder Services—ISS ESG Ratings Model

The ISS ESG Corporate Rating covers 7,300 corporate issuers around the world and has consistently updated its methodology over the last 25 years. This model does not only analyze potential risks, it also measures positive and negative impacts of certain products and services. In addition, the ISS ESG Corporate Rating system monitors controversies and violations of a proprietary set of ISS standards developed, similar to MSCI, from consensus on certain subjects across ESG frameworks, best practices, and industry standards and metrics. ISS provides breakdowns by region, industry, and entity as a part of its ESG rating assessment. This system also establishes a standard of over 30 universal ESG subjects that companies can review and apply to their reporting and analysis.

ISS rates nearly 140 raw data factors that are internally weighted by ISS and then assigned a numeric score from 1-4, alongside ratings on a scale similar to MSCI, from A+ (Excellent) to D- (Poor). The higher the numeric rating, the better ESG performance of the company.

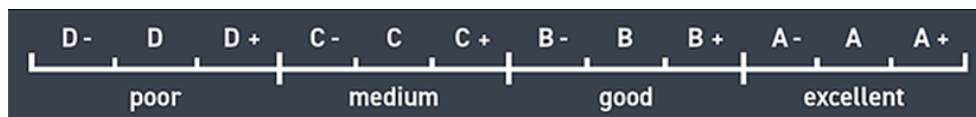


Figure 4: ISS ESG Rating Scale, ISSCorporateSolutions.com

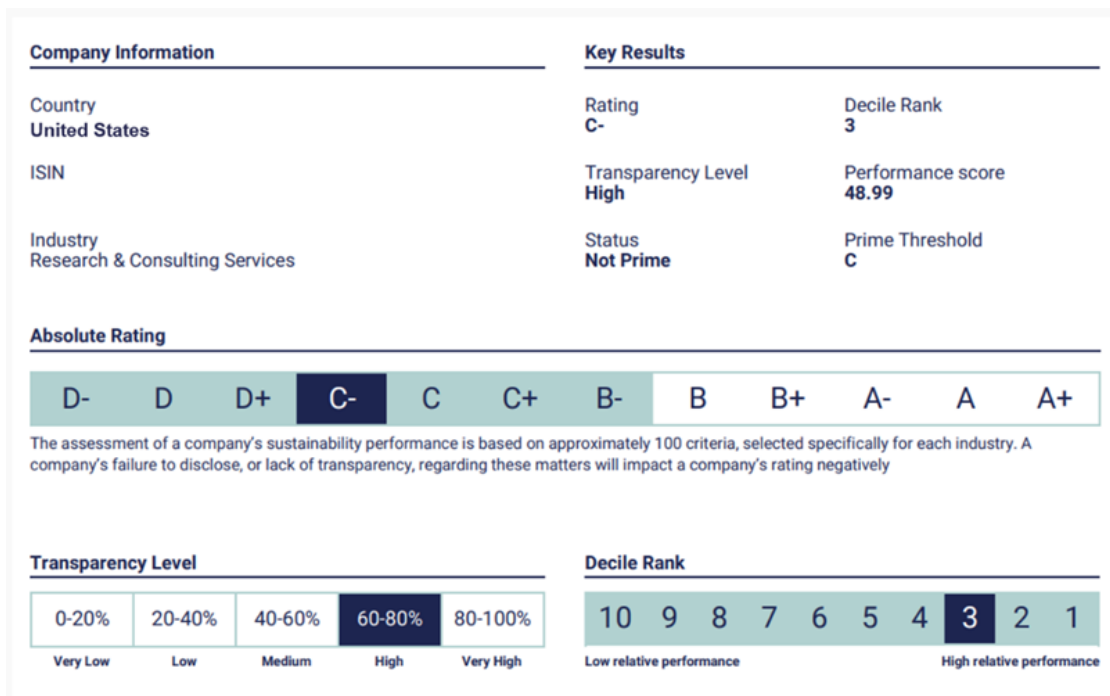


Figure 5: ISS Company ESG Rating Summary, ISSCorporateSolutions.com

Sustainalytics—The Comprehensive Rating Framework & The Core Rating Framework

Sustainalytics is another prominent third-party provider that aspires to be a resource for investors looking to make informed sustainable investment decisions and banks looking to leverage research and ratings in financial risk analysis that supports credit research and lending decisions. Many companies use Sustainalytics to improve their existing sustainability disclosures in the public domain and create targeted investor relations program messaging to harness new investor groups. Sustainalytics uses two separate rating systems based on the market capitalization, which allegedly allows them to produce a more accurate rating that will be more directly comparable to assessments of similar companies. The Comprehensive Rating Framework addresses large and medium cap companies while the Core Rating Framework is intended for small-cap companies that require fewer management indicators.

Key measurement components for ESG Risk Ratings distinguish between manageable and unmanageable risks:

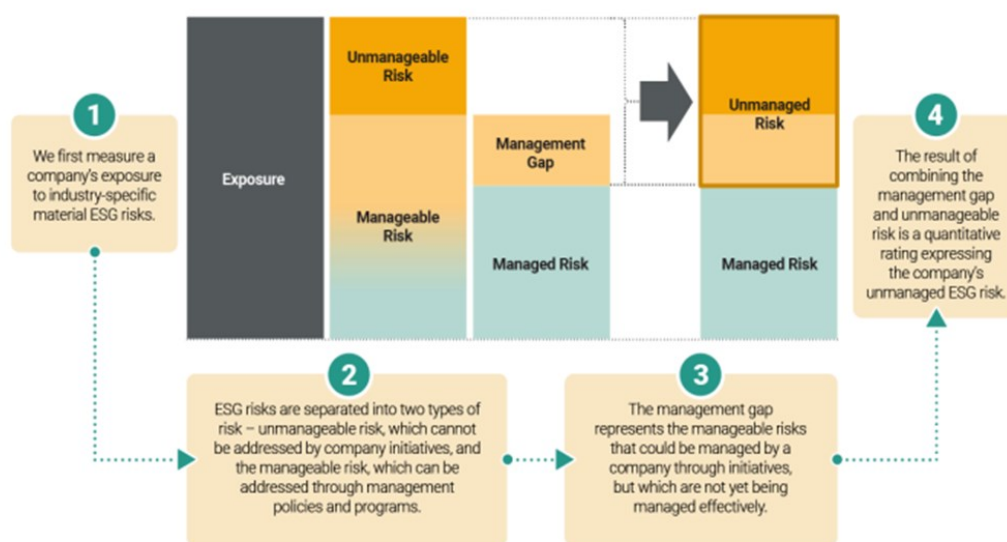


Figure 6: Sustainalytics ESG Rating Methodology, Sustainalytics.com

In 2018 Sustainalytics launched a new ESG research structure, making the rating data from over 4,000 companies publicly available so that investors could use the insights to guide their decisions and companies could evaluate their ESG ratings in comparison to their peers. Since combining resources with Morningstar, Inc. in 2020, Sustainalytics has expanded its ESG ratings universe to over 12,000 companies. To generate their ratings, Sustainalytics considers:

1. Whether and to what extent a company has been **exposed** to ESG-related risks
2. How a company responds to risks and handles **risk management**

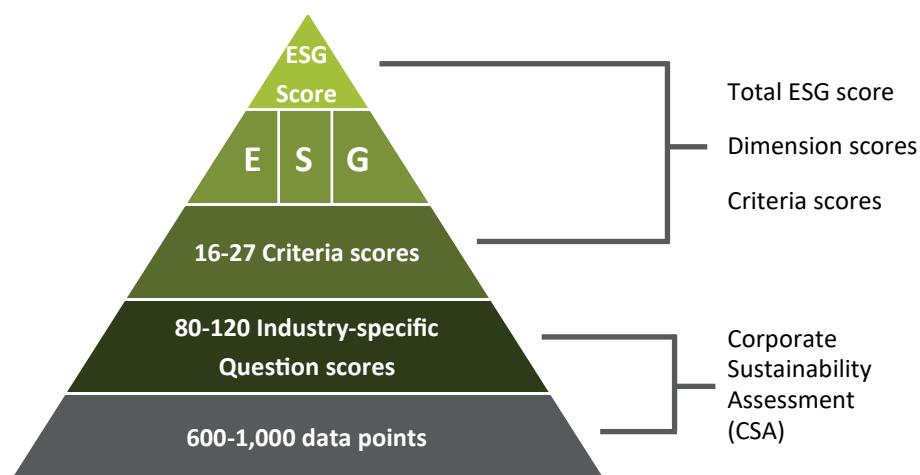
Sustainalytics utilizes five categories of risk severity:

Negligible	Low	Medium	High	Severe
0 - 10	10 - 20	20 - 30	30 - 40	40+

Figure 7: Sustainalytics Five Categories of Risk Severity, Sustainalytics.com

S&P Global—The Corporate Sustainability Assessment

S&P Global is one of the few rating agencies that has begun publishing their ESG reports and scores for the 9,200 companies they service. These scores range from 0-100 for each dimension of ESG and are accompanied by peer comparisons, historical changes, as well as material ESG data by industry. Similar to the approaches over the other rating agencies we’ve covered, materiality is determined by S&P on a proprietary basis, based on industry best practices and metrics S&P considers material for each industry and sector. Their ESG scores include a 5-year score history and feature industry rankings that illustrate the distribution of scores across the industry. The score is comprised of over 1,000 data points from both public sources and other information provided directly from companies using industry-specific questionnaires for each of the 61 sub-industries that S&P covers.



Source: S&P Global Sustainable 1 ESG Research. Chart is provided for illustrative purposes

Figure 8: Components Comprising S&P Global Sustainable ESG Scores, SPGlobal.com

The S&P Global Corporate Sustainability Assessment (CSA) is an annual evaluation of a company’s sustainability practices, which covers both industry-specific and financially material criteria. As of March 2022, over 2,250 companies representing over 45% of global market capitalization elected to participate in the CSA¹¹.

The formula used to get the final weighted S&P Global ESG Scores is:

$$SP_{ESG} = \sum (((SP_{QP} * SP_{QW}) * SP_{CW}) * SP_{DW})$$

Where:

SP_{ESG} = S&P Global ESG Score

SP_{QP} = Question Points

SP_{QW} = Question Weight

SP_{CW} = Criteria Weight

SP_{DW} = Dimension Weight

Figure 9: S&P Global ESG Scores Weighted Formula, SPGlobal.com

11) S&P Global Sustainable 1, [S&P Global ESG Scores - Methodology](#), 2022

The Upright Project—The Net Impact Model

The Upright Project has introduced the world’s first open-access data platform with publicly available impact profile data for over 700 companies, which all stand to benefit from making their sustainable efforts known. Their mission is to make the sustainable efforts of companies more widely accessible, comparable, and ideally, repeatable for other companies as well. The Upright Project’s Net Impact Model is a mathematical model of the economy that uses an algorithm powered by AI to produce continuous updates of the net impacts, with a scope of over 14,000 companies and 150,000 products based on data from over 200 million scientific publications.

What sets this rating model apart from the others so far is that it is user-driven, and the user contributes to setting values that optimize criteria. Their focus is to measure the top-down impacts of products and services, starting from an overall sector impact, rather than on compliance. The main goal of the Upright model is to illustrate the resources that companies use and measure their achievements by using them.

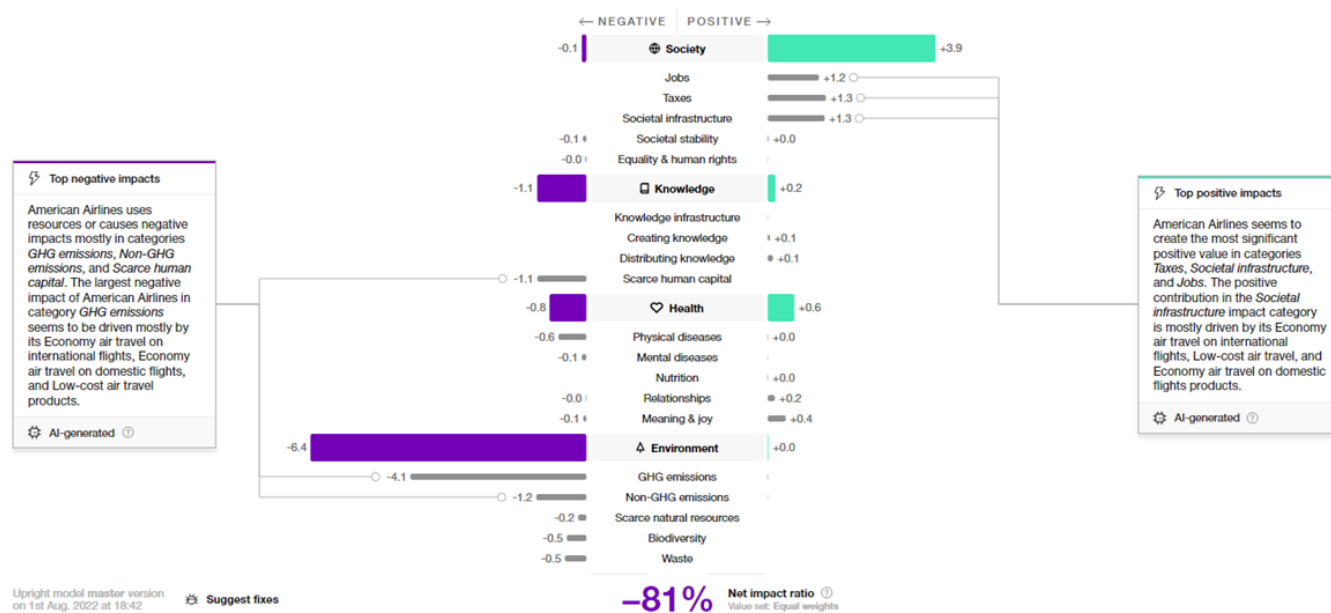


Figure 10: Rating Analysis for American Airlines, UprightProject.com

Unlike Sustainalytics and ISS, higher scores are better in the Upright model, which can range from 100 (being the best) to “minus infinity,” if the company uses a lot more resources that in contributes. This model is effective at providing a big picture for companies to help them understand what they can do to improve their resulting net impact and is less interested in dividing companies into “good” or “bad” categories. This model geared towards resource versus impact optimization, considering the costs of improvements against the benefits they may bring.

The five rating agencies we’ve assessed employ thousands of excellent analysts and have developed sophisticated AI algorithms to generate high quality insights. Opinions of each agency can be valuable to companies committed to ESG risk assessment or reporting. However, the question still stands: Should the ESG ratings these agencies generate be accepted as unequivocal and undisputed, or should they merely be considered as “food for thought”?

Reckoning with ESG Rating Complications & Contradictions—From Tesla to Ukraine

ESG S&P Index Drops Tesla—Keeps Exxon

Arguably the most notable event to date that posed questions about how credible ESG ratings are occurred when the electric vehicle manufacturing company, Tesla, was removed from the S&P 500 ESG Index due to its struggles managing social and governance risks, despite the fact its core product reduces supports the global decarbonization agenda by completely retiring use of conventional fuel-based motors. Tesla notoriously discloses minimal information about its workforce and labor conditions, but numerous reports of workplace injury, leaked emails, and multiple lawsuits ranging the gambit from sexual harassment to racism indicate consistently poor treatment of its employees. The safety of Tesla's driving-assistance features has also repeatedly been called into question and the company has fallen behind its industry peers in addressing such concerns¹².

In response to the exclusion from the sustainability index, Tesla CEO Elon Musk referred to ESG as a “scam,”¹³ while other ESG analysts are considering the move to be overdue. MSCI's inclusion of Exxon has caused many to question the merits of the rating agency and the position behind it. Other notable MSCI moves include increasing McDonald's ratings after the company increased its carbon footprint year-over-year, though some may argue that the rating increase was prompted by the Company's pledge to zero out its climate footprint by 2050¹⁴. In the absence of clear explanations, such decisions leave a bad taste in the mouth of some stakeholders and cause them to question the independence of ratings from other revenue-generating divisions of the agencies.

Either way, ESG ratings have a stronghold on influencing investment decisions—at least based on the 6.8% drop in Tesla's stock on the day the company was expelled from the index¹⁵, while several fossil-fuel companies remained in the S&P ESG Index and even enjoyed ESG rating increases.

MSCI and Sustainalytics Contradict S&P on Tesla Ratings

MSCI is not interested in measuring a company's impact on its surrounding communities—which is why it still rates Tesla as “Average”¹⁶. Instead, MSCI considers the impact of the world on the company and its shareholders, which it promotes as the most financially relevant determinant. What is good for the company financially is not necessarily also good for the environment. If there is no threat to the company's bottom line, environmental issues like emissions are deemed irrelevant by MSCI. This would render Tesla's environmentally friendly electric cars useless in calculations for MSCI's ESG rating for Tesla. Thus, it can be dangerous and misleading, under this model, to deem an investment as “sustainable.” A higher environmental score under this system could mislead investors into believing that corporate actions are positively affecting its carbon footprint while, in fact, it might be the opposite. In the case of the Upright model, Tesla is rated a net positive from an ESG standpoint, offsetting a negative rating for the Company's emissions and reliance on rare natural resources with its positive contribution to employment, infrastructure, and jobs on the “S” side of ESG.

12) The New York Times, [Crashes Involving Tesla Autopilot and Other Driver-Assistance Systems Get New Scrutiny](#), 2021

13) Musk, [May 18, 2022 Tweet](#): “Exxon is rated top ten best in world for environment, social & governance (ESG) by S&P 500, while Tesla didn't make the list! ESG is a scam. It has been weaponized by phony social justice warriors.”

14) Bloomberg, [McDonald's Struggles to Fix Its Massive Methane Problem](#), 2021

15) Financial Advisor Magazine, [Tesla's Removal From S&P Index Sparks Debate About ESG Ratings](#), 2022

16) MSCI ESG Rating for Tesla, Inc., MSCI.com

Sustainalytics currently rates Tesla at 28.5 (medium risk) and places the company in 42nd place out of 83 comparable automobile companies that are ESG-rated¹⁷. While Sustainalytics, MSCI, and S&P Global are all meant to provide ESG ratings, they each have different methodologies leading to discrepancies—like their widely different Tesla ratings.

ESG Priorities Can Contradict Maximizing Wealth—But Not Always

Some states like Delaware have ruled in court that corporations exist primarily to promote value for shareholders¹⁸, which makes it likely impossible to prioritize ESG over wealth maximization. Thanks to the business judgment rule¹⁹, most company boardrooms can operate freely to make decisions about what they believe is best for the company and what the ESG-focused trade-offs to the business are. Many reporting frameworks, such as SASB, request for companies to report on such trade-offs, making the reasoning for decisions transparent to all stakeholders, and thereby acknowledging the frequent tug of war between sustainability and profitability. For example, Dick’s Sporting Goods stood to lose \$250 million in revenue by making the decision to eliminate gun sales after the Parkland shooting²⁰. In turn, the company improved profit margins since other merchandise ended up overperforming and replacing gun sales revenue — demonstrating the true power and essence underpinning integrated ESG decision-making.

Russian Invasion, Sanctions, and Supply Chain Disruptions Complicate ESG Promises

While there are plenty of activists and investors alike who would say climate change is the most important ESG issue, the war in Ukraine has also forced governments in Europe to change their ESG commitments to environmental goals. Country leaders posed the question of whether, over the short term, it would be justified to ramp up fossil fuel use to gain energy independence from Russian gas. The ramp up would justify energy independence, now elevated to the national security and sovereignty level. Russia’s invasion of Ukraine and the resulting sanctions²¹ highlight the inherent ethical choices to be made between the social and environmental components of ESG. The EU depends on Russia for 40% of its gas²², which complicates its ability to decouple those partnerships in compliance with Russian sanctions. Such a scenario highlights potential contradictions in supporting social issues like human rights violations by avoiding trading Russian gas at the expense of relying on other fossil fuel alternatives that are even more harmful to the environment.

Shareholders expect companies to continue proactively cutting ties with Russia²³ and revisit their ESG priorities. According to Bloomberg estimates, there was approximately \$8.3 billion in ESG investments tied up in Russia prior to the invasion²⁴, and divesting those entities from the country has been a bit of challenge though significant capital has left the region.

The debate is now expanding to whether ESG funds should be used to supply defense weapons²⁵ in an unprovoked fight, and if that ultimately qualifies as a net social good. Debates like these reveal the potential for the pillars of ESG to contradict each other, making strict determination of ESG ratings even more difficult and imperfect.

17) Sustainalytics Rating for Tesla, Inc., Sustainalytics.com

18) Forbes, [What eBay’s Court Fight with Craigslist Reveals](#), 2010

19) The business judgment rule is a judicially created doctrine that protects directors from personal civil liability for the decisions they make on behalf of a corporation

20) Fitzgerald, [Dick’s Sporting Goods Followed Its Conscience on Guns – and It Paid Off](#), 2022

21) U.S. Department of the Treasury, [Ukraine -/Russia-related Sanctions](#), Home.Treasury.Gov

22) Bloomberg, [ESG Funds Had \\$8.3 Billion in Russia Assets Right Before War](#), 2022

23) Financial Times, [Are Defence Stocks Now ESG?](#), 2022

24) Bloomberg, [ESG Funds Had \\$8.3 Billion in Russia Assets Right Before War](#), 2022

25) Financial Times, [Are Defence Stocks Now ESG?](#), 2022

Key Takeaways

- **Incongruent Methodologies:** Even though some rating system providers publicly share their rating methodologies, there is still a high degree of ambiguity and propriety. Users of the information must pay agencies' research departments to obtain more detail. To change an ESG rating, companies often are required to become a client of the agency in a “pay to play” way, and work with the agency to gather data and implement suggested improvements. After being removed from S&P's ESG Index, Tesla questioned discrepancies in ESG rating methodologies across all rating providers in their 2021 Impact Report²⁶.
- **Lack of Standardized Rating Metrics:** The sample of ESG rating providers demonstrates just how different each rating system can be. Some agencies use a letter system while others use a numeric rating – and some use either a combination of both or an alternative scale, sometimes inversely related to scales of other agencies. How these agencies categorize, prioritize, and weigh different ESG issues vary greatly, and the lack of transparency into methodologies makes it difficult for users to cross-reference the ratings or be confident in the validity of any rating for a given company. Given the lack of standardization and limited amount of human input into the rating process, it is likely that custom metrics for each issuer are not incorporated or not weighted to the appropriate degree in mass-produced rating reports.
- **ESG Rating Disclosure Limitations:** Neither of the five rating providers analyzed in this paper share the research that back ESG ratings of individual issuers, and some, such as ISS, do not share the ratings unless the issuer is a paying client. While over 80% of the world's largest organizations are self-publishing their ESG reports²⁷ leveraging Global Reporting Initiative, SASB²⁸, and other frameworks, and also submit their climate data to CDP²⁹, many, especially small to mid-cap companies, do not have the resources required to replicate success of the larger issuers. Additionally, it is difficult for small businesses to use large peer reporting models to their own operations because those sustainable initiatives may not apply to them or small scale makes them meaningless, deceiving, or inconsequential. Until reporting is mandatory and standardized, the industry will likely be prone to more discrepancies and disclosure limitations. Standardization and framework consolidation is well on its way, however, bringing more certainty into the evolving ESG reporting standards, which also should allow for more standardization among the rating providers in a foreseeable future.
- **Different Goals:** Rating providers do not pursue the same goals and, therefore, seek to evaluate answers to the same questions using different guiding principles. For example, providers disagree on where the impact focus lies — the company, its financial performance, ESG accounting regulations and compliance, product quality, corporate impact on the environment and climate change, or overall ethics. Some agencies, like The Upright Project, reject the premise of rating a company as good or bad altogether, while others can label them as “severe risk.”
- **Rating Correlation Inconsistencies:** A 2021 MIT study revealed discrepancies in ESG measurements that indicated persistent data quality problems that would have made it impossible to produce accurate ratings³⁰. Another MIT [study published in the Review of Finance](#) in May 2022 shows ESG rating correlation among the most prominent rating agencies is minimal to none, between 38% to 71%, while correlation in credit ratings by key agencies that benefit from more clearly defined regulations is over 92%³¹.

26) Tesla, [Impact Report](#), 2021

27) Sustainalytics, [The ESG Risk Ratings – Moving Up the Innovation Curve](#), 2019

28) GRI, the Global Reporting Initiative, is a provider of sustainability/ESG reporting standards which have become a global model for best practice impact reporting. Covered topics range from biodiversity to tax and waste emissions.

29) CDP is a leading organization helping companies and cities disclose their environmental impact to investors, lenders, and other stakeholders

30) Berg, Et. al, [ESG Confusion and Stock Returns: Tackling the Problem of Noise](#), 2021

31) Berg, Et. al, [Aggregate Confusion: The Divergence of ESG Ratings](#), 2022

- **Biases—Geographic, Industry Sector, and Company Size:** Researchers have identified that large companies experience better ratings than smaller companies and businesses in regions with fewer reporting requirements, such as in North America³². Industry-specific risks do not tend to be accurately reflected in risk exposure measurements because a mass application and top-down evaluation approach is more fit for broader industry applications rather than appreciating the unique corporate story of each issuer.

Therefore, while ESG analysis and rating frameworks can be very useful to leverage for reporting companies, the conclusion of our analysis is as follows:

- In the absence of firm SEC and accounting guidance, like GAAP and IFRS standards³³, ESG ratings provided by agencies must be evaluated in the context of the sustainability philosophy that they support. Therefore, no ESG ratings should be taken at face value without prior stakeholder education on the key premises of the methodology supporting a respective rating. Otherwise, users of this information run the risk of misconstruing the meaning and the significance of ESG ratings, assuming that “BB+”, as in the credit world, is universal and does not have room for liberal interpretation.
- The obscurity of methodologies and public access to details behind the ratings support a “pay to play” model that is counterintuitive to what the agencies are attempting to promote – fair and balanced ESG disclosure that does not violate the SEC Act of 1934. The current revenue model is enabled by restricting access to the details behind corporate ratings and often the ratings themselves, which puts the agencies in a biased position in which it is more lucrative to rate companies poorly to increase paid memberships and revenues from issuers. Alternatively, providers may be incentivized to rate companies well if that influences the buying decisions of the buy-side clientele, which also increases rating agency revenues.

32) Doyle, *Ratings that Don't Rate: The Subjective World of ESG Rating Agencies*, 2018

33) Upon the Value Reporting Foundation's consolidation into the IFRS Foundation, as of July 31, 2022, the IFRS Foundation's International Sustainability Standards Board (ISSB) assumed responsibility for the SASB Standards.

Concluding Thoughts—Are ESG Ratings Meaningful for Value Creation or Sustainability?

The biggest question is whether ESG ratings are actually an accurate reflection of a company's responsibility to make ESG progress. Rating approaches can lack nuance in assessing the unique story of a company and inherent conflicts between the three pillars of ESG make choosing the "right" choice a difficult task at times. With much of the decision-making being governed by AI, ESG ratings may be imperfect and often inconsistent across different rating providers. Subjectivity, bias, and the lack of regulatory standards cause ESG ratings to resemble more closely those of research institutions than those of credit rating agencies.

Our speculation is that the ESG ratings in their current form will be phased-out in their significance and reliance by various stakeholders. In June 2021, the SEC indicated initial considerations for establishing a more standardized set of ESG rules to promote more transparency and prevent greenwashing³⁴. Climate-related disclosure rules and standards were proposed in March 2022 and the public comment period ended on June 17, 2022, for Scope I, II, and III Greenhouse Gas emission reporting. Depending on the regulatory requirements approved, the industry may be moving towards more formalized ESG reporting in the U.S. The same standards and metrics will have to be adopted by the rating agencies, bringing more harmony to currently disbursed methodologies and the resulting ratings.

Improving a company is a continuous process and companies should consider ESG rating agencies as a supplemental asset to guide their materiality-based assessments across the ESG spectrum and consider their analysis as helpful suggestions subject to a company's internal evaluation process. Some ESG rating agencies, like the Upright Project, have begun to slowly move away from the emphasis on the rating and are instead focusing on optimizing results. Prioritizing the result will ultimately reflect in the rating and proves a deeper level of commitment to ESG goals in the process.

We urge readers to remember that the ratings are not an end-all-be-all. We firmly believe that in the current ESG environment, the power of telling a corporate ESG story should remain with the management and the Board because they are the only stakeholders who can properly evaluate material matters, predetermine scenarios, estimate the associated costs of collecting high quality data to be used in the reporting. Though we do acknowledge there is room for dialogue between internal stakeholders and rating agencies, Management and the Board hold the true power to convey the company's story and it is their prerogative to educate the rating agencies on applicability and relevance of their methodology to their unique business model, not the other way around.

34) SEC.gov, [Can the SEC Make ESG Rules that are Sustainable?](#), 2021

ESGiQ

Powered by MZ™

Environmental, Social & Governance (ESG) metrics are rapidly ascending in importance for all capital market participants. Companies monitoring ESG factors tend to be more vigilant on improving overall corporate governance, while increasing profitability and mitigating risk.

Focusing on risk oversight and mitigation strategies, advocating for cultural diversity and inclusion, and being a responsible corporate citizen creates a positive environment for employees and aligns the interests of all stakeholders.

Combining MZ Group's consulting expertise with proprietary software capabilities helps crystallize each of these important components into one complete ESG solution that enables issuers to report ESG metrics in ways that resonate with capital markets participants.



[REQUEST A DEMO](#)

ESGiQ is a user-friendly and interactive software platform designed specifically to customize ESG reporting for private and public companies, as well as ESG focused funds. ESG iQ is the only solution that generates a cross-sectional analysis incorporating Environmental, Social & Governance protocols, with the flexibility to adopt multiple standards.

ESG Consult empowers private and public clients to obtain greater insight into ESG best practices, while preparing them to track, monitor and properly report their material ESG factors to various stakeholders, rating agencies and financial media.

Please visit www.mzgroup.us/esg-iq-platform or email esg@mzgroup.us to learn more or to schedule a demo today

About MZ Group

MZ North America is the US division of MZ Group, a global leader in investor relations and corporate communications. MZ North America was founded in 1996 and provides full scale Investor Relations to both private and public companies across all industries. Supported by our exclusive one-stop-shop approach, MZ works with top management to support the clients' business strategy in six integrated product and service categories: 1) IR Consulting & Outreach – full service investor relations and roadshow services; 2) ESG Consulting – reporting technology platform and audit and reporting guidance; 4) SPAC Advisory – providing critical and timely guidance through business combination; 5) Financial & Social Media – lead generation and social media relations; 6) Market Intelligence – real time ownership monitoring; 7) Technology Solutions – webhosting, webcasting, distribution services, conference calls, CRM, and board portals. MZ North America has a global footprint with offices located in New York, Chicago, San Diego, Aliso Viejo, Austin, Minneapolis, Taipei and São Paulo.