

Investor protection

ESG ratings: Status and key issues ahead

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Summary

As sustainable investing gains traction, ESG ratings are growing in importance for investors and issuers, while gaining attention from global media. This article describes the market for ESG ratings, including types of ratings and key providers, and presents several use cases. In the absence of a regulatory framework, several issues and risks reduce the potential benefits of these ratings. The lack of a common definition and of comparability, together with transparency issues, could be ultimately detrimental to the transition towards a more sustainable financial system. To illustrate the impact of these issues on investors, our analysis focuses on the specific case of ESG benchmark construction.

Introduction

Global sustainable investing has gained enormous traction in recent years, with estimates putting the total value of assets following sustainable investing strategies at EUR 45 trillion in 2020, twice the 2016 value (J.P. Morgan, 2020). This includes more than EUR 2.5 trillion in institutional assets tracking ESG ratings and scores (*The Economist*, 2019).

Still, the market is in its infancy, and in new markets of this type the identification and generation of reliable and comparable market data typically plays a central role in its development. With estimated global spending on ESG data at EUR 500mn according to Opimas (2020), including 60 % from Europe, the market for ESG data is still small, despite its rapid growth. In comparison, global revenues of financial data service providers were EUR 26 bn in 2019¹⁵⁹. However, with annual growth expected to average 20 % over the coming years, several large players have made the development of ESG data-related products a central part of their business strategy.

ESG ratings and scores are of particular interest. These form a broadly homogeneous product group offered by companies aiming to provide

investors with an objective data-driven third-party assessment of ESG-related aspects. Under the European Green Deal, such assessments are bound to grow in importance even though they are currently unregulated, while the firms producing them are bound to gain influence albeit they remain largely unsupervised (AMF and AFM, 2020).

Reflecting these expectations, media coverage has grown significantly in the last 2 years. The view that ESG ratings are 'not ready yet for the weight they are being asked to bear' appears to prevail, with many articles conveying the view that rating methodologies are opaque, and their ratings subjective and inconsistent (see *The Economist*, 2019; *Financial Times*, 2020a,b).

This article takes stock of the current situation. First, we explore the diversity of ESG rating products, the specificities of this market and its key players. Second, we summarise the issues documented in the literature and media, in particular with regard to the lack of comparability and reliability of ratings. Third, we present some use cases and illustrate the impact that these issues can have. In particular, our analysis shows that the choice of ESG rating provider has significant implications for the composition of ESG indices, which can lead to material

¹⁵⁸ This article was authored by Julien Mazzacurati, with research assistance from Klaas Lenaerts and Carolina Asensio.

¹⁵⁹ 'Burton-Taylor releases annual financial market data/analysis industry vendor rankings', 27 August 2020.

differences in financial outcomes. We then conclude by summarising the key risks arising from the current state of the market.

The market for ESG ratings

Main types of ESG ratings

There is no official or common definition of ESG ratings. In a recent letter to the European Commission, ESMA (2021) proposed the following broad definition: 'ESG rating means an opinion regarding an entity, issuer, or debt security's impact on or exposure to ESG factors, alignment with international climatic agreements or sustainability characteristics, issued using a defined ranking system of rating categories.'

ESG ratings, scores and other quantitative ESG assessments ('ESG ratings' henceforth) can measure different aspects. Based on the definitions used by some providers, they can be regrouped into two main categories.

- **ESG risk ratings** are the most common form, measuring the exposure of entities to ESG risks and how these risks are managed. Examples of such ratings include MSCI ('resilience to long-term, industry material ESG risks'), Sustainalytics ('exposure and management of material ESG issues affecting a company's enterprise value'), S&P ('exposure of an entity's operations to ESG risks and opportunities') and FTSE Russell ('exposure to, and management of, ESG issues').
- **ESG impact ratings**, on the other hand, measure the impact of entities on ESG factors. This category would include ratings from providers such as Refinitiv ('relative ESG performance, commitment and effectiveness'), Moody's ('willingness and capacity to integrate sustainability criteria'), ECPI ('sustainability measure'), Sensefolio ('ESG involvement') and Inrate ('environmental and social impacts').

Differences between such 'risk' ratings and 'impact' ratings can be thin, as they are built using comparable methodologies and tend to rely on similar metrics. ESG ratings can also be backward-looking or forward-looking, depending on their goals. Most ESG ratings cover corporate issuers but a few providers also offer ratings focusing on local governments or countries.

A myriad of alternative products also exists. These span, for example, the extent to which a firm discloses ESG-related information (Bloomberg), or ESG relevance scores looking at whether ESG issues influence the normal credit rating of a firm (Fitch Ratings). While such alternative products may not be ESG ratings in the traditional sense, they also signal that there are material ESG risks that could affect a firm's valuation or viability. Others produce ratings focusing on one of the three pillars (environmental, social or governance), such as governance quality scores from ISS and climate risk ratings from 427.mt. Within the environmental category, a number of providers offer carbon risk ratings, including firms with large coverage (Moody's, MSCI, Sustainalytics) and more specialised ones (Trucost, Carbon Delta, StyleAnalytics).

This wide variety of ratings mirrors to a large extent the diversified demand coming from multiple types of clients and how the information is put to use. A large majority of asset managers favour such variety, even as many support greater standardisation and transparency (Sustainability, 2020a).

ESG ratings versus credit ratings

Both ESG and credit ratings are data-driven assessments sold by third-party providers. However, ESG ratings have some specific characteristics (other than the object they try to measure) that clearly differentiate them.

A credit rating is an opinion regarding the creditworthiness of an entity or instrument based on a ranking system of rating categories. Under the requirements of the CRA Regulation¹⁶⁰, a credit rating is expected to include substantial analytical input from an analyst (through qualitative factors or a qualitative judgement). Credit scores, on the other hand, are not required to have a qualitative element. They are a measure of creditworthiness derived from summarising and expressing data, based only on a pre-established statistical system or model. In an ESG context, no such distinction between ratings and scores exists, and current ESG data limitations imply that both ESG ratings and scores need to rely on some form of qualitative input.

Unlike credit ratings (among which both issuer- and instrument-level ratings are common) ESG

¹⁶⁰ Regulation (EC) No 1060/2009 on credit rating agencies.

ratings tend to be at issuer level – although some rating providers map issuer ratings and listed securities. This is mainly because most financial securities finance not ESG-specific activities but the whole range of activities of the issuer (with the exception of use-of-proceeds bonds or impact bonds). In addition, ESG-related issues and data (CO₂ emissions, gender pay gap, etc.) are usually associated with overall company characteristics rather than specific activities.

Another fundamental difference between credit ratings and ESG ratings is the payment model. The ‘issuer pays’ model, mainly used by CRAs and widely blamed for contributing to ratings inflation before the 2008 financial crisis, is not yet fully replicable in the context of ESG ratings, as not all issuers currently attach informational value to their ratings. Instead, the ‘investor pays’ model appears to be commonly used. Investors pay a fee depending on the type and range of products they wish to access, as well as the level of granularity and method of access to data: ‘headline’ ESG ratings or underlying information, current or historical ratings, delivery channel, etc.¹⁶¹.

ESG ratings are also unique in that most cover three distinct pillars, yielding different environmental, social and governance scores subsequently aggregated into a single ESG score. This responds to the demand for a simple, unique ESG score, including for portfolio management purposes. However, it is problematic for several reasons. Given the greater availability of quantitative metrics and ongoing policy efforts, environmental ratings are likely to achieve standardisation and credibility sooner than, for example, ratings on social-related issues (Berg et al., 2019). Furthermore, aggregation is not straightforward: some rating providers simply give equal weights to all three pillars for lack of a better approach, while others apply weights reflecting the materiality of the issues considered in each pillar.

Lastly, assessing the accuracy of ESG ratings constitutes a major challenge. This stems primarily from measuring outcomes of a qualitative nature with a long-term horizon, such as shareholder engagement and social issues. It also implies that ESG ratings may remain in a

state of permanent relativity. The most basic accuracy test for a credit rating is the default or not of the instrument or issuer, leading the credit rating scale to flow naturally from safest to defaulted for all businesses. In comparison, there is currently no easy way to perform *ex post* assessments of the quality of ESG ratings.

ESG rating providers

In line with the absence of a regulatory definition of ESG ratings, there is no clear understanding of the criteria under which firms may or may not ‘qualify’ as ESG rating providers. Reflecting this, estimating the total number of firms active in the market for ESG ratings is a challenge. A study from SustAinability (2020b) estimated that there were over 600 ESG ratings and rankings globally in 2018; other studies by SSgA (2019) and KPMG (2020) found the number of rating providers to be somewhere between 125 and 150. Among them, there appears to be currently around 10 to 15 major providers (SustAinability, 2020a).

Regardless of its actual size, the industry appears to have experienced significant consolidation in recent years. This has often occurred through large companies buying their way into the market, such as S&P and Moody’s acquiring, respectively, the ESG rating arms of RobecoSAM (January 2020) and Vigeo Eiris (April 2019), itself the result of an earlier merger in 2015. Other examples include MSCI buying GMI Ratings (2014), the purchase of Oekom Research by ISS (2018), Morningstar’s two-step acquisition of Sustainalytics (in 2017 and 2020) and the take-over of Beyond Ratings by the London Stock Exchange Group (2019)¹⁶². A study from the AMF (2020) identified as many as 30 instances of ESG mergers and acquisitions since 2009.

There are no data on ESG ratings’ market shares, reflecting the absence of a common definition and the fact that few providers make available financial disclosures on their ESG-related rating activity. A recent survey of 319 sustainability experts found that MSCI and Sustainalytics were the most frequently cited providers, followed by CDP and ISS (SustAinability, 2020b). The number of companies covered by ESG rating providers varies from c. 4 000 to 12 000 (RA.1).

¹⁶¹ A detailed analysis of providers’ fee structure is available from SustAinability (2020a).

¹⁶² See ‘S&P Global finalizes acquisition of the SAM ESG Ratings and ESG Benchmarking Business from RobecoSAM’, 10 January 2020, ‘Moody’s acquires majority stake in Vigeo Eiris, a global leader in ESG

assessments’, 15 April 2019, ‘MSCI to acquire GMI Ratings’, 27 June 2014, ‘Oekom research AG to join Institutional Shareholder Services’, 15 March 2018, ‘Morningstar Inc. completes acquisition of Sustainalytics’, 6 July 2020, and ‘London Stock Exchange Group acquires Beyond Ratings’, 3 June 2019.

However, this number is not representative of relative market shares, since clients usually pay to access a range of ratings at once – making coverage a marketing tool – while many providers sell an array of products based on their data and research (corporate ratings, country ratings, city ratings, governance ratings, carbon risk ratings, etc.)¹⁶³.

RA.1

Number of corporate ESG ratings from selected providers
More than 8 000 companies rated on average

ESG rating provider	Number of companies rated
Bloomberg	11 700
FTSE Russell ^a	7 200
ISS	4 000
MSCI	8 500
Refinitiv ^b	10 000
S&P Global	7 300
Sustainalytics	12 000

Note: Number of corporate ESG ratings from selected ESG rating providers based on publicly available information. The numbers may cover more than one ESG rating product type.

^a Number of rated securities.

^b Number of companies for which ESG data are available.

Sources: Company websites, ESMA.

Most ESG rating providers base their assessments, to varying degrees, on publicly available data, such as corporate reports and disclosure or news items. Some also explicitly mention that they rely on AI techniques to analyse information. Finally, a number of firms rely in addition on information obtained directly from issuers, through questionnaires and interviews, or on third-party data. The number of ESG analysts per provider varies from fewer than 20 to more than 200, reflecting their size, presence (local or international) and focus on technology (AMF, 2020).

Based on their core business area, ESG rating providers can be broadly categorised as follows:

- **CRAs:** Several CRAs started offering ESG ratings as an additional service to their clients, including S&P, Moody's and Fitch Ratings.
- **Benchmark administrators:** Some index providers such as MSCI and FTSE Russell produce ESG ratings and use them to create ESG indices.
- **Data vendors:** Data platforms (e.g. Bloomberg and Refinitiv) make ESG ratings available to clients subscribing to their services, while fund

data providers such as Morningstar or Refinitiv Lipper use ESG ratings to rank funds based on their portfolios.

- **Specialised firms:** A number of smaller specialised providers for which ESG risk metrics and analytics form the core of their business have not been acquired. This category includes for example Sensefolio, RepRisk, HIP Ratings, Qivalio and EcoVadis SAS.
- **Consultancies:** Some consultancy firms (e.g. Apex Group, Mercer) produce ESG ratings on specific aspects or segments of the market (unlisted companies and fund investment strategies respectively) to inform their investors.

There is some overlap between these categories, with the recent market consolidation trend reflecting a broader strategy by large conglomerates to offer multiple types of financial data-related services. For example, ratings from MSCI and Sustainalytics serve as input to both benchmark indices and fund ESG ratings. Alternatively, providers can be categorised based on their business model, e.g. those specialised in ESG-related products and services vs those offering in addition non-sustainability-related products and services (SustAinability, 2020a).

Literature: performance and consistency in focus

Most of the literature focuses on the relationship between ESG ratings and asset performance, without a clear consensus emerging. A comprehensive review of the existing literature on the topic by Boffo et al. (2020a) finds that industry research tends to find a positive correlation between ESG scores and performance, whereas academic research generally shows a negative one. This may reflect disagreement between ESG rating providers, including on materiality and how to measure it. For example, highlighting the impact of such disagreement, Gibson et al. (2019) show empirically that higher dispersion in ESG ratings from six providers about social and governance factors leads to overvaluation of S&P 500 shares and subsequent negative returns. Using multiple approaches, Boffo et al. (2020a) also find no clear evidence that ESG-oriented

¹⁶³ Sustainalytics claims to be 'The largest independent provider of ESG research and ratings', while MSCI advertises itself as 'The world's largest provider of ESG indices' (which are based on MSCI ESG ratings). Arguably, market shares could be calculated in various

ways: client spending on ESG ratings and data, ESG-rating provider revenues, assets under management following ESG ratings, etc.

portfolio indices and funds systematically outperform non-ESG peers.

The divergence between ESG ratings is documented by Berg et al. (2019), who use ratings from five prominent data providers. They find that ESG ratings are only 60 % correlated, compared with 99 % for credit ratings from the largest CRAs. This is mainly explained by differences in measurement (i.e. measuring the same object in different ways) and aggregation rules, leading the authors to draw the conclusion that standardisation of the measurement procedures is required.

Disagreement between ESG ratings is confirmed by Billio et al. (2020), who attribute it to a lack of commonality in the definition of environmental, social and governance components. Disagreement leads in particular to discrepancies among ESG indices, with very low agreement rates on the constituents of comparable indices (in terms of coverage and sector composition) from four different providers, even after controlling for geographical differences. In the next section, we illustrate how disagreement between ESG rating providers can impact benchmark composition.

Escrig-Olmedo et al. (2019) aim to understand to what extent the criteria used by ESG rating providers in their assessment processes have evolved over the last 10 years. They highlight that providers have a clear commercial character, since they market diverse products and services (sustainability indices, sector and thematic research reports, benchmarks, etc.), leading to a significant increase in their bargaining powers. This implies a biased concept of sustainability if four basic principles are not guaranteed in this business: balance among sustainability dimensions, intergenerational perspective, stakeholder approach and life-cycle thinking.

Coverage by global media and analysts of ESG ratings has grown significantly in the last 2 years, in line with growing investor interest and widespread acknowledgement that the relevance of ESG ratings is bound to increase. Some ESG rating providers have successfully turned this into a profit¹⁶⁴. But, despite the higher demand for third-party sustainability advice, the view that ESG ratings are 'not ready yet for the weight they are being asked to bear' appears to prevail, with many articles conveying the view that rating

methodologies are opaque, and their ratings subjective and inconsistent (see *The Economist*, 2019; *Financial Times*, 2020a,b).

Both the academic literature and the media also question the broader usefulness and reliability of ESG ratings in achieving sustainable outcomes. Boffo et al. (2020b) find a positive correlation between high environmental scores and high level of CO₂ emissions and waste. In the same vein, a recent study highlighted that a third of the 33 climate funds sold in the UK are invested in oil and gas companies. Such issues, as well as the inclusion of well-known polluters in mainstream ESG indices, are easily picked up by the press, raising questions in the investment community about the value of ESG ratings and labels. Other examples of ESG rating divergence are not lacking, with Tesla frequently cited as receiving a top ESG score from one ESG rating provider while another gives it the lowest grade. Investors may not understand the differences because the methodologies are proprietary – or rely on confidential data from a third-party commercial provider – nor is the issuer always in a position to explain its scores publicly (*Financial Times*, 2020c,d; *Responsible Investor*, 2020).

The user case: applications of ratings

Despite their shortcomings, there is broad agreement that ESG ratings will increasingly be integrated into business decision-making. A recent CFA study (2020) of 2 800 investment practitioners found that 85 % already took environmental, social and/or governance factors into consideration when investing, mainly driven by demand from clients. The examples in this section show how ESG ratings are currently used.

Investors and issuers

Asset managers use ESG ratings to construct portfolios according to their mandates (e.g. thematic investing) or to monitor and manage certain types of exposure (e.g. climate related). In the most direct way, ESG ratings can be used as a screening tool to identify relative outperformers

¹⁶⁴ MSCI's ESG research division has experienced an annual increase in turnover of 30 % in 2 years (*Financial Times*, 2019).

and underperformers within a sector, or to exclude certain companies from a portfolio (negative screening), e.g. because of major controversies or other ESG-related issues.

However, not all investors rely on ESG ratings to the same extent. According to a survey conducted among professional investors (Sustainability, 2020b), most use ESG ratings only as one of several inputs in a larger process. They can be incorporated into existing valuation models, serve as indicators signalling that further research into an issuer is warranted or benchmark a company's ESG performance against its broader sector. Many investors rely on in-house ESG expertise, either because they find it more reliable or because it allows them to tailor the research specifically to their needs, which can help reduce the effect of disagreement between external rating providers.

Green bonds and sustainability-linked instruments provide other examples of how ESG ratings can serve as an input. Second-party opinions ahead of a green bond issuance frequently involve an assessment of the issuer's sustainability credentials, which some external reviewers provide either in the form of an ESG rating or based on information and processes available from a pre-existing rating¹⁶⁵. Some sustainability-linked bonds and loans see their interest or coupon rates increase if the ESG rating of the issuer falls below a predetermined threshold.

ESG ratings can also be used by non-financial firms, for example to assess the financial and sustainable performance and regulatory compliance of customers or suppliers, to manage their own image and improve disclosure, or to inform voting decisions by shareholders. Another survey among 'sustainability professionals' shows that 72 % of corporate respondents use ESG ratings to inform their decision-making (Sustainability, 2019). They also use them to compare themselves against competitors.

ESG rating-based products

There are broader applications for ESG ratings in the sphere of financial services. Integration

allows some CRAs to feed the data underpinning ESG ratings into credit ratings. Similarly, ESG ratings are used by index providers to create new indices. S&P Dow Jones offers a range of ESG indices based on SAM's (formerly RobecoSAM) Corporate Sustainability Assessment, which it acquired in early 2020; several STOXX sustainability indices rely on ESG ratings from Sustainalytics; and MSCI's 1 500 ESG indices are constructed using its own ESG ratings¹⁶⁶.

The lack of consistency between ratings documented by Berg et al. (2019) or Billio et al. (2020), and confirmed by others¹⁶⁷, is particularly problematic in the context of ESG index construction. Companies may or may not qualify for an ESG rating-based index depending on the rating provider, while growing sums of money are being allocated to these indices through passive investing. The market for ESG benchmarks is highly concentrated: in December 2020, 17 out of the largest 20 ESG ETFs tracked ESG indices from the same index provider, according to data from ETFGI, with combined assets of EUR 57 bn. With global ESG ETF assets tripling to EUR 121 bn in 2020 and more than half of new European ETFs integrating sustainable criteria into their investment process, the magnitude of these issues seems likely to further increase, including in Europe (RA.2)¹⁶⁸.

¹⁶⁵ This is the case, for example, for second-party opinions from ISS-ESG and Vigeo Eiris. See examples in the International Capital Market Association's sustainable bonds database (<https://www.icmagroup.org/sustainable-finance/green-social-and-sustainability-bonds-database/#508>).

¹⁶⁶ 'How does S&P Global ratings incorporate ESG risks into its ratings analysis', 21 November 2017.

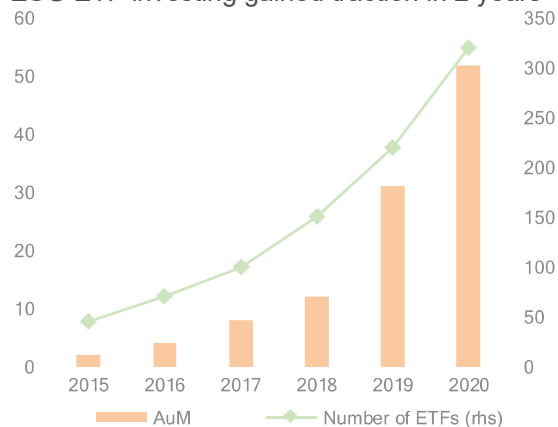
¹⁶⁷ A study by SSgA (2019) finds a 53 % correlation between four leading ESG rating providers. Boffo et al. (2020a) find average correlations across three rating providers of 21 % and 18 % respectively for the S&P 500 and STOXX Europe 600 constituents.

¹⁶⁸ 'TrackInsight reports record assets in European, North American and ESG ETFs', 7 December 2020. ETF Stream, 'The year of ESG', 10 December 2020.

RA.2

Number and AuM of European ESG ETFs

ESG ETF investing gained traction in 2 years



Note: Assets under Management of European ETFs, EUR bn, and number of ETFs (right axis)
Sources: Refinitiv Lippert, ESMA.

Index replication

To illustrate how the choice of ESG rating provider matters in index construction, we focus first on the constituents of the Euro STOXX ESG Leaders 50 Index. The benchmark administrator uses ratings from Sustainalytics to identify global 'ESG Leaders' from the 1 800 constituents of the STOXX Global 1800 Index. Out of these global 'Leaders', the 50 largest EA companies (by market capitalisation) form the Euro STOXX ESG Leaders 50 Index. However, not all ESG rating providers agree on the 'ESG Leadership' credentials of these companies. Between 62 % and 72 % of the companies identified by Sustainalytics as 'Leaders' are deemed to be so by MSCI and Refinitiv; the three providers agree on only 40 % of the index constituents (RA.3).

RA.3

Euro STOXX ESG Leaders 50: constituents' rankings

Disagreement on ESG leaders' ratings

	Sustainalytics	MSCI	Refinitiv	RepRisk
Leader	50	32	37	11
Average	—	18	13	26
Laggard	—	—	—	13

Note: Number of companies from the Euro STOXX ESG Leaders 50 Index (based on ratings from Sustainalytics) by ESG rating and rating provider. 'Leader' includes AAA and AA (MSCI and RepRisk), A+, A and A-; 'Average' includes BBB, BB and B (MSCI and RepRisk), B+, B and B- (RepRisk). 'Laggard' includes everything below. Differences in ratings may be due to definitions, methodologies or data sources, but also adjustments made to account for relative differences in company size, sector and domicile. All ratings as of December 2020. Sources: Datastream, MSCI, Refinitiv EIKON, RepRisk, STOXX, ESMA.

As highlighted by Berg et al. (2019) and Billio et al. (2020), such differences reflect to a large extent fundamental differences in measurement methodologies, including data sources¹⁶⁹ and the absence of standardised definitions.

We then replicate the methodology underpinning the STOXX Global ESG Leaders Index to identify 'ESG Leaders' using ESG ratings from alternative providers, starting from the same original pool of 1 800 companies. To qualify as an 'ESG Leader', a company must i) score in the top 50 % in all three pillars (environmental, social, governance), and ii) score in the top 25 % in at least one pillar¹⁷⁰. Out of the 1 800 companies, 413 (23 %) pass both thresholds according to Sustainalytics, thus composing the STOXX Global ESG Leaders Index. We apply the same criteria to ESG ratings downloaded from Refinitiv and RepRisk and find that 359 (20 %) and 759 companies (42 %) respectively would qualify as 'ESG Leaders' (RA.4)¹⁷¹.

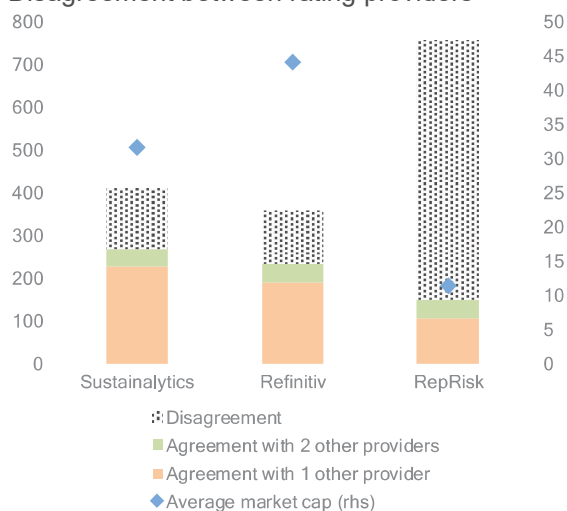
¹⁶⁹ For example, RepRisk ratings are based on ESG risk incidents documented by media sources, non-governmental organisations, etc. as opposed to company disclosures. RepRisk: ESG data science and quantitative solutions, www.reprisk.com.

¹⁷⁰ Sustainalytics also applies a 'Global Standards Screening', which screens news items from non-governmental organisations and media for incidents in potential violation of the UN Global Compact. While no

such assessment is available in Refinitiv, we looked at companies' ESG controversy scores and found that around half of 87 companies with a 'poor' controversy performance according to Refinitiv were included in the Global STOXX ESG Leaders index.

¹⁷¹ MSCI makes a large number of its corporate ESG ratings publicly available on its website, but these cannot be downloaded in bulk and are therefore out of scope for this exercise.

RA.4
Number and market caps of global ESG Leaders
Disagreement between rating providers



Note: Number of companies from the STOXX Global 1800 index identified as 'ESG Leaders' according to three ESG rating providers, and average market capitalisation (right axis), EUR bn. 'Agreement' means that a company would qualify as 'ESG Leader' according to at least two ESG rating providers. 'ESG Leaders' must score in the top 50% in all three pillars (environmental, social, governance) and in the top 25% in at least one pillar. Ratings and data as of December 2020.
 Sources: STOXX, RefinitivEIKON, RepRisk, ESMA.

The highest rate of agreement is between Sustainalytics and Refinitiv, with 156 companies identified as 'ESG Leaders' based on the ESG ratings of both firms. This corresponds to 38 % and 43 % respectively of the total numbers of 'Global ESG Leaders' identified using their ratings.

Again, methodologies and data sources play a key role here and lead to significant skews in the data due to company size. Both Sustainalytics and Refinitiv base their ratings on a wide array of metrics weighted according to an in-house materiality assessment. Sustainalytics ratings aim to assess companies' exposure to and management of ESG risks using a combination of public data, information obtained directly from issuers, alternative data sources and own estimates. In contrast, Refinitiv ratings exclusively rely on publicly available information. While the latter approach promotes greater transparency, it is skewed towards larger companies that have sufficient resources to dedicate time and staff to non-financial reporting. RepRisk ratings rely on an alternative approach, capturing reputational risk exposure to ESG issues based on ESG risk incidents sourced from

global media, NGOs, local news sources, etc. This approach also favours transparency but penalises larger companies more exposed to public scrutiny (despite some adjustments being made in the scoring). The existence of such biases is reflected in the size of companies that qualify as 'ESG Leaders', with average market capitalisation nearly five times higher for companies identified as 'ESG Leaders' using Refinitiv ratings than using RepRisk ratings.

Lastly, to illustrate the implications from these differences for indices that use ESG scores as a weighting scheme, we create a synthetic index replicating the methodology of the Euro STOXX ESG Leaders 50 Index using Refinitiv ratings as of December 2020¹⁷². Since 18 March, the replicated index has outperformed its benchmark by a cumulative 12 pps, reflecting their different compositions (RA.5).

RA.5
ESG equity indices performance
Annual returns diverge by 8 percentage points



Note: Euro STOXX ESG Leaders 50 Index and replication index using Refinitiv ESG ratings, rebased with 1/1/2020=100.
 Sources: Datastream, RefinitivEIKON, STOXX, ESMA.

The 50 constituents from both indices have a comparable average market capitalisation of EUR 52 bn, i.e. EUR 2.6 trillion combined. The indices have 30 constituents in common (60 % overlap), with half of the companies in the replicated index that are not part of the benchmark seeing gross returns in excess of 70 % since 18 March. This mainly reflects differences in sectoral composition: these outperformers operate mainly in the automobile and other industrial sectors, which experienced

¹⁷² The index constituents are weighted based on the normalised environmental, social and governance scores (as of 2020) of each company relative to its peers. Owing to the scoring methodology and resulting number of 'ESG Leaders' with no reputational risk (i.e. a 0 score), RepRisk

ratings are not suitable to compute company weights that could be used in this particular exercise. For a full description of the methodology, see STOXX (2020).

large share price increases in November related to COVID-19 vaccine announcements, while telecom companies included in the benchmark index underperformed (see 'Sustainable finance', above, pp. 46–47).

While such differences can work in both directions, they are far from trivial: a retail investor buying EUR 10 000 worth of ESG ETF shares in March may in theory find herself or himself better or worse off by EUR 1 000 at the end of the year, as a result of the choice of ESG rating provider made by the benchmark provider. Asset managers with in-house expertise and financial resources value variety in ESG ratings and depth of analysis across providers. However, for retail investors buying ESG rating-based products such as ETFs, the full implications of the choice of ESG rating provider on their investments are not as clear and may entail significant search costs.

Risks ahead: more transparency needed

The current situation creates several risks. First, the absence of a common definition prevents authorities and investors from mapping the market, and leaves the definition of ESG risk to rating providers. This leads to misunderstandings about the objectives and comparability of ESG ratings, and high rates of disagreement between providers on the ESG credentials of companies.

The second problem concerns the transparency of methodologies that underpin ESG ratings. To produce ratings, providers use proprietary methodologies in line with their objectives and definitions. Methodological differences may stem from conscious choices in terms of scope, factor weights or aggregation methods. They may also reflect measurement divergence of the same attributes, such as the type of indicators or metrics used, or, more fundamentally, differences in the quality and consistency of ESG-related company disclosures. The French and Dutch securities markets authorities point out that such transparency issues may lead to investment misallocation, mismatches between expectations and ESG outcomes, or even greenwashing, while they prevent the integration of sustainability risks

and opportunities in the investment-making process (AFM and AMF, 2020).

The current situation reflects in part the current state of the legislation; future improvements in the consistency and scope of climate-related disclosures following revisions of the EU Non-Financial Reporting Directive¹⁷³ should help. ESG rating providers have currently little choice but to rely on data of uneven quality that might penalise the absence of disclosure, and benefit larger firms able to afford disclosure (see for example *Financial Times*, 2020e). One related problem regularly cited by investors is the lack of information regarding the assumptions made where data are incomplete, insufficiently granular or simply unavailable (Boffo et al., 2020a).

The third risk stems from competition in the ESG rating market. While the recent wave of acquisitions may help reduce heterogeneity to some extent and arguably raise standards in the ESG rating market, it leads to greater concentration of the market within a few large rating providers. In the medium term, the risk is of recreating an oligopoly situation similar to that of the credit rating market. Oligopolistic markets enable firms to exercise market power to increase prices or reduce quality of output. Typical competition-related issues that can lead to significant consumer detriment include pricing above competitive levels, risk of collusion, entry barriers, and reduced innovation and efficiency. The AMF and AFM (2020) also highlight the risk of reduced coverage for smaller issuers.

Finally, risks of conflicts of interest may originate from the coexistence of ESG rating service provision with other business areas. 'Ratings shopping' by issuers should be limited given the predominance of the 'investor pays' model. Instead, such conflicts may arise in the context of other products or services being sold to investors. For example, ratings from benchmark administrators may be influenced by their core activity, either to suit investors' needs in terms of, for example, representativeness or underlying liquidity, or simply to ensure sufficient robustness of index composition. Even though ESG rating service provision is typically carried out in separate legal entities, commercial interests or regulatory requirements concerning other business activities may lead to conflicting priorities. Similar issues may also arise within

¹⁷³ Directive 2014/95/EU as regards disclosure of non-financial and diversity information by certain large undertakings and groups.

asset managers, financial data providers and firms carrying out green bond verification or certification. The risk of ratings inflation from such potential conflicts of interest may contribute to a lack of comparability and trust.

Conclusion

ESG ratings are useful in that they allow investors to obtain an external opinion on the sustainability credentials of companies and countries. ESG rating providers can play a valuable role through structured assessments based on rigorous methodologies, extracting value across thousands of issuers from ESG disclosures through their rating process (Boffo et al., 2020a). Thus, they have an important role to play in facilitating the transition to a more sustainable economy, allowing the optimal allocation of capital to cleaner companies and infrastructures. In addition, ESG ratings and providers incentivise companies to improve their ESG credentials and levels of disclosure.

However, these benefits are hampered by several key concerns. The absence of a common definition for ESG ratings leads to investor and issuer confusion and misunderstandings. While the existence of different methodologies and approaches reflects the diversity of client needs, varying degrees of methodology and data transparency further limit the comparability of these ratings and the ability to understand what the main drivers and limitations are. Our analysis shows that these matters have a very significant impact on the composition of ESG indices, while a growing amount of money tracks these indices through passive ESG funds and ETFs. The coexistence of ESG ratings with other business activities in several ESG rating firms, such as credit ratings, benchmark construction, consulting services or asset management, further creates fertile ground for potential conflicts of interest.

This has significant implications for investor protection, with potential misalignment between investor expectations and investment outcomes, but also for sustainable development in the long run because of the potential mispricing of ESG-related information (Van Heijningen, 2019). The inconsistency of ESG ratings also leads to issues down the investment value chain: investment misallocation may result, either unintentionally through ESG rating-based indices, or intentionally from greenwashing and product mis-selling. These issues are ultimately detrimental to

investor confidence and to the transition towards a more sustainable financial system.

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