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HOW TO APPROACH ESG RATINGS

The need for sustainability and adherence to ESG (Environmental, Social and Governance) principles in a company's business has increased in recent years and is in a phase of rapid growth. Lots of companies want to do business in a sustainable way, and others want to be perceived as trend setters, gain a competitive advantage and seek an ESG rating.

What does the term "ESG rating" actually refer to? Is it a legal obligation, or is it an additional aspect connected to sustainability and ESG reporting? What constitutes a favorable ESG rating?

ESG ratings play an important role in today's emphasis on sustainability information. ESG rating agencies and providers may improve the reliability of actions related to a company's ESG strategy. Without a doubt, ESG ratings offer many benefits and added value for a company. They may help in gaining a competitive advantage, attracting investors, obtaining capital, building customer loyalty, helping make a company's operations more sustainable, driving sustainability initiatives, bolstering the company's image and reputation and even improving financial performance.

Some tend to compare ESG ratings to credit ratings, as the rating terminology is used for both. Credit ratings have been used for decades by investors as a factor in their well-informed investment decisions, to assess the creditworthiness of a company from the financial perspective or of a particular financial obligation. Given the growing significance and demand for sustainability, many investors have also started to incorporate ESG ratings into their analysis to better inform and support their investment decisions. ESG ratings generally look at the performance or risk profile of the company by analyzing the data in environmental, social and governance pillars using numerical scores or letter grades.

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Whereas credit ratings tend to be more consistent among the providers, ESG ratings differ significantly. Currently there are several hundreds of ESG rating providers and the lack of unification and the fact that ESG rating is not regulated result in key differences in following areas:

1. Definitions and materiality;
2. Approaches to data collection, assessment and scoring;
3. Transparency of methodology and scores, and
4. Whether companies can review for factual errors.

Different ESG rating providers use different approaches and there is a variety of ways in which ratings are presented. ESG rating methodologies often lead to very different assessments of the same company. ESG ratings by various providers are not comparable, they cover different topics, use different metrics and weight to measure ESG performance. Some ESG ratings reflect the impact a company has on the environment and on its stakeholders. Only a few ESG rating providers measure the impact that societal and environmental factors have on a company and take into account the financial materiality of these factors.

Some providers present ESG ratings in a numerical and some in the letter format. In both cases, even the logic differs. For instance, with certain ESG ratings, a higher number signifies better performance, while with other providers, the opposite holds true.

The users of ESG ratings must be knowledgeable, understand the differences between ESG rating providers in order to correctly interpret and evaluate the results. Comparison and benchmarking of companies even from the same industry is very problematic.

The inconsistent data disclosure by companies suggests that ESG rating providers occasionally rely on estimations and employ industry proxies in their reports. This may be partially addressed by ESG reporting regulation through EU Taxonomy Regulation, Sustainable Finance Disclosure Regulation (SFDR), Corporate Sustainability Reporting Directive (CSRD) and related European Sustainability Reporting Standards (ESRS), which are unifying the methodology for sustainability information disclosures and require mandatory independent assurance, thus contributing to transparent and comparable sustainability reporting.

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The rapid development of ESG ratings and the substantial disparities among ESG rating providers and their methodologies have prompted significant criticism. There is a growing demand for standardized criteria that would establish a unified definition of what should be measured and how ESG ratings should be assessed. In recent years, the swift and disjointed growth of numerous ESG providers has made it challenging for companies, investors, and other stakeholders to keep pace with these developments. This has resulted in mounting stakeholder pressure and a notable shift towards a more streamlined and coordinated approach among major ESG rating providers. The consolidation of ESG ratings would result in increased transparency and reduced greenwashing, as regulatory oversight of ESG ratings is expected to deter misleading claims regarding ESG performance.

Until this happens, companies need to consider important aspects when deciding on a particular ESG rating provider. The purpose of ESG rating is one of the key factors to consider. To effectively prepare for an ESG rating, it is essential to comprehend the research, rating methodology, and the specific areas assessed by the chosen rating provider. Since ESG affects virtually all functions and departments within a company, fostering communication across the entire organization is imperative. This facilitates a seamless process and ensures that employees grasp the company's intentions and priorities, enabling the collection of essential information and data.