Louvain School of Management
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# What is the value of ESG ratings for responsible investors in allocating capital towards sustainable companies?

## Evidence from European institutional investors

Research Master's Thesis submitted by
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## Executive Summary

There is a strong momentum to complement traditional financial measures with sustainability indicators. In that regard, the ESG ratings market plays a role of intermediary between the corporate and the investment sectors. However, rising concerns over their relevance imply that trillions of capital might be wrongfully allocated. This thesis aims at assessing the value of this tool for institutional investors, by understanding the necessity to integrate this sustainability research in responsible investment strategies. This paper investigates the various main ESG ratings providers and their methodologies, as well as the challenges encountered in their application. An in depth analysis of both an academic review and nine interviews with small to very large institutional investors across Europe comes to the following conclusion: ESG ratings enable to make sustainable investment mainstream, by offering unrivalled coverage and the broad expertise the market needs. Their use comes with many drawbacks, but precautions, such as in-house research, are taken by investors. The recent scrutiny from the European Commission around this tool will probably unveil the importance of sustainability ratings in the sustainable finance agenda. More transparency and affordability are required to develop this ESG ratings market in the right direction, thus allocating capital towards sustainable companies.

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# Table of content

# Part 1 Introduction

A global megatrend to reorient capitals towards sustainable investments is gradually surging. However, for investors, gathering Environmental, Social and Governance (ESG) criteria in a single sustainability information for each company has proven to be a daunting and a costly task. Complaints from some asset managers have arisen: "We have positions in over 4,500 companies. Unless [sustainability information] is comparable, hard data, it is of little use to us." (McKinsey & Company, 2019). In this breach the "ESG ratings[1]" appeared, playing the role of intermediaries between companies and investors. From there, ESG ratings providers have gained the power to make a distinction between a firm performing well and another performing badly. Until now, the level of public scrutiny has remained low, but a new momentum is rising: in Autumn 2019, the European Commission launched a study on the state of play of sustainability research and ratings.

The validity of ESG ratings is increasingly questioned by academics, companies, and investors, casting doubts on its relevance. Some may recall that in 2015, shortly before the "Dieselgate bomb" was dropped, Volkswagen climbed to the top of the sustainability podium in its industry according to the Dow Jones Sustainability Indices. If those scores are invalid, this sheds light on trillions of dollars that might be, or have been, misleadingly allocated. The reputation of score providers, such as specialized agencies, traditional providers and data providers, is thereby tarnished. In this context, this paper will assess the use of this tool, and provide recommendations to foster transparency in this flourishing market. More specifically, the research question is: **What is the value of ESG ratings for responsible investors in allocating capital towards sustainable companies? Evidence from European institutional investors.**

ESG ratings are increasingly under the spotlight and have been the subject of many pieces of research. Academics, consulting firms, think tanks and institutional investors previously sought to address the question of reliability in those scores. Many studies draw

[1] Throughout this paper, ESG ratings and sustainability ratings will be used interchangeably.

concerns about the low convergence between the various providers (Chatterji, Durand, Levine, & Touboul, 2016; Dorfleitner, Halbritter, & Nguyen, 2015), or exploit the potential sources of confusion (Berg, Koelbel, & Rigobon, 2019). This research is building on this momentum, adding on to the criticism and limitations of ESG ratings.

Both a systematic review of the academic literature and interviews with institutional investors (asset managers, fund managers, investment managers) will inquire further in the subject. This work adds on to the existing literature by exploring the perspective of investment management professionals, who use sustainability ratings. Nine interviews with small to large European investors are performed. It assesses the relevance of ESG ratings and investigates the criteria for selecting a provider, while exploring some inevitable limits. This paper focuses on the value of ESG ratings for investor in assessing adequately firms' sustainability performances, without exploring the dimension of its incorporation in valuation. The deductive approach of the thesis unveils academic findings and adds on to the numerous pitfalls of ESG ratings.

Within the literature review, the first chapter explains the growing importance and interest for sustainable finance. It also illustrates how ESG ratings are embedded in this industry. The paper then explores the sustainability ratings in depth, through the lenses of its providers and main stakeholders. The following chapter draws a portrait of the ESG ratings market, and investigates the methodologies put in place by the most renowned providers. The last chapter in the academic literature delves into the numerous limitations and drawbacks of sustainability ratings. Eventually, interviews with institutional investors will further answer the research question. Both the literature and the interview analysis will lay the basis for a comprehensive discussion aiming at answering the research question.

# Part 2 Literature review

## Chapter 1 Mounting interest for sustainable finance

*There can be no Plan B, because there is no Planet B.*

Former UN Secretary-General, Ban Ki-Moon

Global warming and biodiversity loss, two mass shootings in the US in less than 24 hours in 2019, Dieselgate in 2015: Environmental, Social and Governance-related issues are pervasive, and a matter for the whole society. Many researchers and industries offer to tackle them. The question is: why should finance be part of the solution? This chapter will dig into the premises of sustainable finance (SF), by understanding its uninterrupted increase in the past two decades and the promising future it may have. A thorough analysis of the current scientific literature will allow to put into words the concrete meaning of sustainable investing, and how ESG ratings are embedded in that concept.

### Section 1.1. The premises of sustainable finance

#### 1.1.1. Sustainability challenges

Climate change is not the only aspect included in the definition of Corporate Social Responsibility (CSR), i.e. the responsibility of enterprises for their impact on society (European Commission, 2019). As much as climate change, companies should be concerned about tackling social inequalities, child labour, resource scarcity, migration, demographic growth, or depletion of ocean biodiversity. Because of those negative externalities (*cfr*. further explanations Section 2.3), firms should play a pivotal role in sustainable development.

*In fine*, what does sustainable development means? On the one hand, it is described as a development "which meets the needs of the present without compromising the ability of future generations to meet their own needs" (WCED, 1987). On the other hand, the EU High Level Expert group on Sustainable Finance defines sustainability as "making economic prosperity long-lasting, more socially inclusive and less dependent on exploitation of finite resources and the natural environment" (EU High-Level Expert Group on Sustainable Finance, 2018).

In 2015, the United Nations developed a framework for a sustainable ecosystem that should be followed by all stakeholders. Because "We cannot address the climate change crisis without the full participation of the global business community" (UN Global Compact, 2019), the 2030 Agenda for Sustainable Development and the 17 SDGs[2] (United Nations, 2015) are meant to guide societies, but also companies towards a responsible and future-proof economy (*cfr.* Appendix I. ). In that matter, finance should fulfil those goals by channelling capital so as to promote responsible and sustainable behaviour within companies.

### 1.1.1. Sustainable finance

With this ever-growing interest for the corporate role in sustainable development, we might wonder: how can finance contribute to a sustainable future and trigger a more responsible behaviour in the business community?

*The role of finance in sustainable development*

Financial institutions act as intermediaries, transferring capital from one individual to another (Schoenmaker & Schramade, 2018). Meanwhile, those institutions are the fuel of the economy, by providing liquidity which fosters the development of activities, at levels that would be unattainable otherwise. Their main role is to optimally allocate funding to various industries, and to secure risk-adjusted return to their clients. It may seem that the link between sustainable development and core finance is somewhat indirect. However, after the Financial Crisis in 2008, nobody can deny that financial institutions can have a tremendous negative impact on the economy. As a result, finance can be considered as a major player in this transition, as allocation of funding can have both positive or negative repercussions on sustainable development. Thus far, finance has played a significant role in increasing negative impacts from firms, in using only financial and return-based criteria for investment decision-making.

According to Olaf Weber, who based his research on the "Brundtland Report" (WCED, 1987) "studies suggest that the indirect emissions created through financing industries are 50

[2] Sustainable Development Goals.

to 200 times higher than direct emissions caused by financial institutions" (Weber, 2015). In the Brundtland report it is stated that:

"*Sustainable finance* is finance that meets the social, environmental, and livelihood needs of the present generation without compromising the ability of future generations to meet their own needs and that creates a fair balance between societies in the north and the south." The core objective of (sustainable) finance should be to help finding a trade-off in the so-called triple bottom-line (people, planet, profit), a term popularized by John Elkington at the end of the 20th century. With this approach, social and environmental criteria should be considered as crucial as economic criteria for any investment decision (Elkington, 1998). We must remember that SF does not consider that financial performances should be forgotten, but rather adjusted to ESG performances.

*ESG integration in investment decision-making*

In the framework of this master thesis, the focus is put on the use of ESG ratings for investment and lending decision-making. It appears then appropriate to further develop the principle of ESG integration.

ESG investing stands for Environmental, Social and Governance investing. Quite surprisingly, this is not a new concept. Indeed, many investors had for years factored in sustainability criteria alongside profit-driven motivations (CFA institute, 2015). The considerations were not explicitly named as ESG-related, but an evaluation of the reputational risk of a company, or of the resource scarcity and ageing population, already took place in the past in fundamental investment analysis.

A phenomenon that emerged following the discussion of ESG investing is the consideration of long-term value creation (LTVC). Consequently, sustainable investing should aim at tackling short termism. In finance, short term investing is described as excessively focusing on quarterly earnings without taking into account long-term consequences. In **Figure 1**, Dirk Schoenmaker and Willem Schramade highlight the role of the financial institutions, that is creating value in the long run by using the 2030 Agenda for the SDGs (*cfr*. Appendix I. ).

As businesses play a key role in sustainable development, they should move a step forward from a shareholder to a stakeholder perspective (Schoenmaker & Schramade, 2018).

This way, boards of directors would be decreasingly incentivized to look after short-term results and would be increasingly pushed to take into account employees, clients, governments and suppliers, while emphasising long-term needs. Incidentally, in August 2019, the Business Roundtable – a leading conglomerate of US CEOs representing nearly 200 US companies – stated that they "urge leading investors to support companies that build long-term value by investing in their employees and communities" (Business Roundtable, 2019).

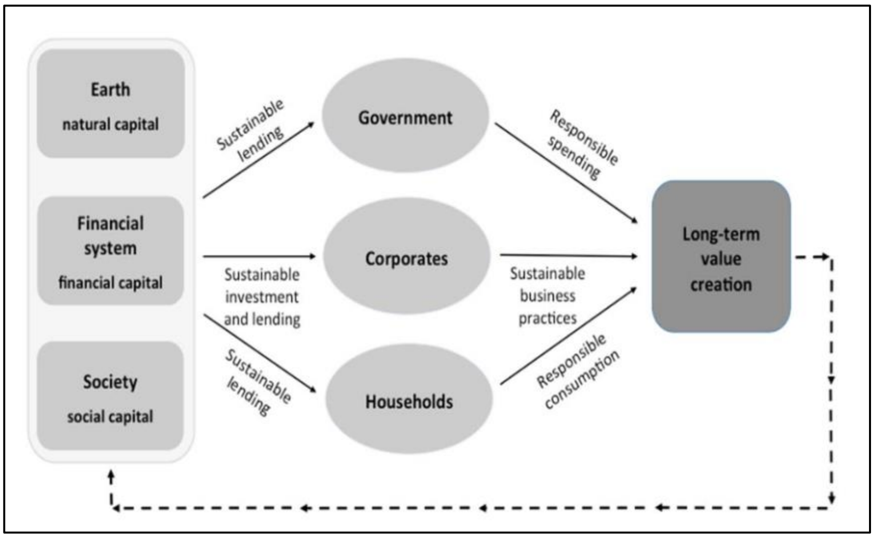


***Figure 1*** *Value Creation: From an old to a new vision (Schoenmaker & Schramade, 2018)*

Channelling funds to companies taking an LTVC perspective faces however some challenges. First, developing a long-term investing policy is more accessible to medium or large investors, as they have larger means to build internal ESG expertise. Small players might face budgetary issues in developing internal research (e.g. to have a more engaged dialogue with investee companies). This topic is further addressed in the analysis part (see Chapter 7). The World Economic Forum, in its 2011 "The Future of Long-term Investing" report (World Economic Forum & Oliver Wyman, 2011), listed four constraints related to the long-term investment perspective:

- "*Liability profile* – the degree to which the investor must service short-term obligations, such as upcoming payments to beneficiaries. Institutions that might need to liquidate a significant percentage of their assets to meet short-term obligations are restricted in making long-term investment decisions

- *Investment beliefs* – if the institution believes long-term investing can produce superior returns
- *Risk appetite* – the ability and willingness of the institution to accept potentially sizable losses
- *Decision-making structure* – the ability of the investment team and trustees to execute a long- term investment strategy”

Indeed in the case of pension fund for instance, there are short term obligations which need to be met, as retirees count on their pension. Long-term investing should be a well thought out process, and not a “reading the tea leaves” process as individuals count on their monthly revenues.

## Section 1.2. Sustainable assets: a growing emergence

In July 2004, the former UN Secretary-General Kofi Annan proposed a UN Responsible Investment Initiative. Four years later, it would become the UN Principles for Responsible Investment (*cfr*. Point 2.2.4) – constituting one of the most “important steps towards fulfilling the Millennium Development Goals and commitments of the World Summit for Sustainable Development” (PRI, 2019). More than fifteen years after, this topic has nearly become mainstream, especially in 2019.

According to the Global Sustainable Investment Review provided by the GSIA[3] (2018), as of the end of 2018, the total number of assets labelled “sustainable” reached a record amount of $30.7 trillion in the five main markets (Europe, US, Japan, Canada, Australia/New Zealand). The ever-growing number of fund managers concerned by sustainability seems quite encouraging as well. In his article written for Bloomberg Opinion in June 2019, Mark Gilbert shows that among 600 asset owners across 46 countries, 78% already acknowledge ESG considerations in their routine work, where 17% do consider that ESG investing will be adopted in the near future (Gilbert, 2019). From this observation, it seems logical that ESG ratings and data emerged proportionally. The market for ESG rating services has boomed throughout the last years, with a projected growth of $745 million for 2020. This number means that in

[3] Global Sustainable Investment Alliance.

comparison to 2018, it has soared by 50%, and by 300% since 2014 (Chasan & Poh, 2019). Over the past seven years, Bloomberg approximates that the number of terminal customers using ESG data has more than tripled (Bloomberg, 2019), reaching nearly 18,000 users worldwide.

In this introductory chapter, the emergence of sustainable finance has been touched upon, as well as the approaches to integrate ESG assets. We were able to witness to what extent sustainability ratings are used, as well as their paramount availability in the previous years.

# Chapter 2 Rationale under ESG ratings and their use

Throughout the previous chapter, an overview of ESG ratings within sustainable finance was presented. Now the time has come to dig into the substance of ESG ratings. Firstly, this chapter explores the meaning of this tool. Secondly, it sheds some light on the concept of *conscious investors* and the extent to which they can display various interests. It then describes how companies are willing to report and to improve their rating. Eventually, the European Union vision in terms of ESG ratings is further investigated.

## Section 2.1. ESG ratings in depth

ESG ratings are ratings that allow investors to assess the quality of a company or a fund regarding environmental, social and governance criteria (Cash, 2018; Schoenmaker & Schramade, 2018; Huber & Comstock, 2017; Clementino & Perkins, 2020). Just as a credit rating provided by the CRAs – credit rating agencies – would do for *financial* performances, ESG scorings enable a comparison between several companies on the grounds of *sustainable* performances. Used by financial institutions, investors, or other professionals, they help gauge whether a company is future-proof. An ESG score can be attributed to a company, to disclosures or to specific securities, such as fixed income, equity, loans, ETFs[4] or market indices. ESG ratings can offer alternative measures for several factors including for instance $CO_2$ emissions, gender balance, safety data, employee attrition and water pollution.

As we concluded in the introductory chapter, the growing demand following the urge of sustainable investing highly encourages the use of ESG ratings, data and indices. As most investors do not have the capabilities or the resources to undertake a scoring for each company, many of them rely considerably on ESG ratings, provided by several analysts, established as intermediaries (Drempetic, Klein, & Zwergel, 2019). In this context, third parties ESG scorers have emerged. Sustainability data can be provided in several ways (raw data vs scores and topic-focused vs comprehensive), as stated in **Table 1** below with examples. This table does not include credit rating agencies (which will be explored later on in this chapter).

[4] Exchange-traded funds.

| | *Raw Data* | *Scores/Rating/Advices* |
|---|---|---|
| *Topic focused* | Southpole | CDP Climate Disclosure Score, ISS-Ethix |
| *Comprehensive* | Bloomberg ESG Data Service, RepRisk, Thomson Reuters | RobecoSAM (through DJSI), Sustainalytics, MSCI |

***Table 1*** *Examples of Sustainability Data Providers (Schoenmaker & Schramade, 2018)*

### 2.1.1. Sustainability rating agencies

Many investors rely on the main ESG data providers, that is the Sustainability rating agencies (SRAs). They collect information from different sources, such as sustainability reports, public information, or direct requests via companies. Each SRA develops methodologies (*cfr*. Chapter 3) to provide an assessment or an opinion on how well a company is performing according to ESG criteria, using a proper scoring scale (Cash, 2018). On **Table 1**, SRAs belong to the second column, by offering scores, ratings or advices, and may both give a topic focussed or comprehensive assessment. In 2016, there was an estimate of more than 100 rating agencies delivering ESG ratings, such as Sustainalytics, MSCI or RobecoSAM (Amel-Zadeh & Serafeim, 2017).

Thus far, no international consensus was reached regarding the methodology for assessing and scoring ESG-related aspects. Contrary to CRAs approach, where the companies issuing debts are paying to be rated on their creditworthiness (issuer-pays model), most of the SRAs are paid by the investors directly to provide an assessment or a scoring on ESG parameters. Thanks to this evaluation, one knows how well a company is performing compared to peers, or according to certain sustainable criteria.

### 2.1.2. Credit rating agencies

In the light of the success of ESG ratings, credit rating agencies are willing to have a say in this fruitful sustainability market. Initially evaluating the creditworthiness of a company – that is giving a score on the ability of a company to repay its debts –, the CRAs are contributing to the sustainability wave.

Instead of creating a specialized ESG scoring, the oligopoly of CRAs – Standard & Poor's, Moody's and Fitch – rather aims at incorporating an ESG assessment within the credit scoring directly (even though some have started to develop a stand-alone ESG evaluation, as seen in Section 3.3). Because the main purpose of a CRA is to give an opinion on the riskiness of a company, it is generally the governance criteria that matters the most, impacting greatly the "future-proofness" of a firm. When environmental and social issues are strongly related to the sustainability of a company in the long term, then the CRAs might incorporate it into their overarching score, but to a lower extent (Cash, 2018).

### 2.1.3. In-house ratings

It may happen that financial institutions have themselves the capabilities and the means to develop their own internal ratings. They develop in-house ratings to help building the investment decision process (Chasan & Poh, 2019).

Many investment or commercial banks incorporate scoring methodologies when lending or influencing investing decisions. Proper teams with experts from different fields are built, and entire departments created. DNB – Den Norske Bank – is as many others incorporating sustainable investment and own scoring methods to evaluate the ESG performances of a company (DNB, 2020).

### 2.1.4. Financial information platforms

ESG Ratings can be delivered from an additional category of providers, which we will call in this thesis "financial information platforms".

The Bloomberg Terminal is also considered as a main player in the ESG rating industry. Indeed, by increasing the accessibility to ESG data, analytics and indices, investors gain an easy access to ESG scoring. The Bloomberg Terminal collects, validates and shares the data provided by companies and data providers (Bloomberg, 2019). By displaying ESG concerns directly alongside financial performances, it allows investors or other stakeholders a direct access to sustainable ratings (*cfr*. Appendix II. ). Bloomberg itself offers a disclosure score on companies. It also created, among others, the <BI SDG> function, which allows to determine which revenue streams of a certain business segment come from an SDG-related source. This tool builds SDG-related ESG metrics that a company discloses (Bloomberg, 2019).

In the same vein, Refinitiv, a global supplier of financial markets information and data, has developed a strong interest for sustainable finance. It can be considered as an ESG Rating providers, as it has developed an ESG scoring method to measure the sustainability performance levels of a company (Refinitiv, 2020). The aim of Refinitiv is to provide "transparent and objective" scores.

### 2.1.5. Sustainable indices

As indices are broadly used in terms of investment decisions based on financial performances, it is worth spending some time understanding how the indices may be relevant in the context of ESG investing. The world's first ESG index was elaborated by KLD – Kinder, Lydenberg, Domini Research & Analytics – in 1990 (Fowler & Hope, 2007). It took several years before other sustainable indices emerged, such as DJSI, FTSE4 or Vigeo.

According to FTSE Russel, an index is "an indicator or measure of something. In simple terms, in the world of investing, an index is a hypothetical portfolio of securities designed to represent an asset class, market, or market segment" (FTSE Russel, 2020b). Sustainability indices represent assets which "behave" sustainably. The construction of indices mostly come from ESG data providers, such as rating agencies. Some other stakeholders might help in the creation of indices, such as researchers, NGOs or international agencies. In most cases, sustainable indices are built in a way that puts more weight on companies that are performing well in terms of ESG. On that basis, investors may choose to invest in specific areas perceived as important for them, or for their clients.

## Section 2.2. Why do conscious investors use ESG ratings?

### 2.2.1. Types of investors and motivations

As a rising concern emerged on the impacts of ESG issues on business performances, investors are willing to integrate sustainable criteria in their investment decisions. In relying on ESG ratings, sustainable investors can reduce information asymmetry between companies and investors, and avoid large costs of analysing an overwhelming number of firms themselves (van Duuren, Plantinga, & Scholtens, 2016).

According to their different objectives, conscious investors may be divided in two main categories labelled (Cash, 2018):

- **Institutional investors**: assist asset owners (e.g. pension funds, life insurance funds, mutual funds, etc.) with their investment practices;
- **Retail investors**: make investment decisions for themselves, with their own resources (e.g. high net worth individuals, families, private traders, etc.).

In the context of ratings, one should keep in mind that investors are not necessarily driven by the same motivations. While gender parity and child labour may appear the most material concerns for one investor, another could materialise GHG[5] emissions at a higher level. The term materiality indicates, in this context, relevant and significant information (Schoenmaker & Schramade, 2018). Within the framework of this thesis, one should keep in mind that different people have different views – and sometimes even drastically different – about the meaning of ESG impacts. However, the underlying psychological aspects of this finding will not be further investigated in this paper.

The remaining question that should be addressed is the motivation underlying the use of ESG ratings. According to a study co-written by George Serafeim – Harvard professor and pioneer in sustainable finance –, the main reason for investors to use ESG data relies in its link to financially material performances (Amel-Zadeh & Serafeim, 2017). The second motivation considers sustainable ratings as overriding in terms of active ownership. Besides that, more and more asset owners are asking for better sustainability performances (on E, S and G), which institutional investors should include in their mandate.

### 2.2.2. Underlying ESG concerns in investment decisions

According to the CFA[6] institute, investors' willingness for ESG integration has shifted over the years. In view of a reputational risk mitigation, professionals are now considering ESG performances to manage risks. According to this same study (CFA institute, 2015), despite a special attention for climate change issues, in 2015 investors were more concerned about board accountability, thus the 'G' criteria. We should, however, take a step back in reviewing this study, as it was carried out in 2015. Since then, ESG concerns from financial institutions and stakeholders have soared (as seen in the introductory chapter). It is therefore paramount to

[5] Greenhouse gas.
[6] Chartered Financial Analyst.

consider more recent studies. The Global Impact Investing Network (GIIN), for example, showed in a 2019 global study that the primary impact objectives of investors are more focused on social than environmental issues. Respectively 75% and 61% of the respondents answered targeting the SDGs "Decent work and economic growth" and "No poverty" as more material (GIIN Research Team, 2019).

The 2018 Ernst and Young research on environmental, social and governance investor perspectives (EY, 2018) allows to draw conclusions on the current perception of sustainable choices for **institutional investors**. In this report, 93% of the respondents consider that "ESG ratings or assessment from investment data providers" are essential to somewhat useful, as a primary source for nonfinancial information (EY, 2018). Nevertheless, company reports, equity researches and press coverage come as preferred criteria when making an investment decision. Another study (Dyck, Lins, Roth, & Wagner, 2016) shows that institutional ownership is correlated with positive ESG performance ratings, thus demonstrating that sustainability matters to investors. In the Principles of Sustainable Finance book, the authors raise the issue of long investment chains, unveiling the reliance on market metrics (ESG data, ratings and indices) of institutional investors (Schoenmaker & Schramade, 2018).

Taking now the individual perspective, the recent Sustainable Signals report by Morgan Stanley leads to some conclusions on the drivers pushing **retail investors** to invest sustainably (Morgan Stanley, 2019). One should bear in mind that this study was produced among 800 US individual investors, with minimum investable assets of $100,000. The first observation is that the interest for sustainable investing skyrocketed in 2019 compared to the previous years, with 85% of the general population and 95% of Millennials showing their ESG concerns. Another finding relates to the lack of data quality. Indeed, individuals "cited the need for better data on sustainability" (Morgan Stanley, 2019). This suggests that ESG ratings seem too broad, lacking common metrics, according to those investors.

#### 2.2.3. Methods for integrating sustainability into investment decisions

The CFA institute (2015) states that "for investment professionals, a key idea in the discussion of ESG issues is that systematically considering ESG issues will likely lead to more complete analyses and better-informed investment decisions". According to CFA and most of the responsible investment community, ESG parameters in investment can be taken into account through six methods:

1. **Exclusionary or negative screening** – based on certain values, investors decide to exclude companies in their investments.
2. **Best-in-class selection or positive screening** – depending on ESG criteria, investors decide to keep investing in companies that perform best in comparison with their peers.
3. **Active ownership** – dialogue with investee companies enabling investors to have an impact as per ESG preferred criteria. This can be made through voting rights to influence the company in the "right" direction.
4. **Thematic investing** – focus on investments which consider specific ESG trends.
5. **Impact investing** – investment with a stated intention to see performances on ESG criteria from the company.
6. **ESG integration** – explicit integration of ESG criteria into investments.

In the context of ESG ratings, how can investors use scores within those methodologies? Literature states that only two methods should be considered through ratings (Schoenmaker & Schramade, 2018). Firstly, an exclusionary screening can be carried out on scores, because it does not require the investor to be active. It is one of the oldest methods taking into account ESG performances in investment decision-making. In 2018, Eurosif[7] presented a list of top exclusion criteria for investors, which is widely accepted in Europe and throughout the world: weapons, tobacco, gambling, pornography, nuclear energy, alcohol, GMO (genetically modified organisms) and animal testing (Eurosif, 2018).

The second method that may use ratings is the best-in-class approach. In order to compare peers, the methodology is based on the region as well as the sector the company fits in. ESG scoring enables to compare several companies under precise criteria, leading to the final decision to keep the one that performs best in terms of sustainable rating. ESG data appears absolutely necessary to investors when relying on best-in-class/positive screening in the

[7] European association for the promotion and advancement of sustainable and responsible investment across Europe.

decision making. It seems that ratings are not yet fitting in the remaining methodologies, because they would require from investors a deeper analysis of the investment possibilities as well as of the underlying ESG criteria. However, in the near future, the increasing data quality for ESG concerns will help enhancing the reliability on ESG ratings in many investment methodologies (current criticism about their lack of reliability will be discussed in Chapter 4). Indeed, a large number of investors are still sceptical about those sustainability assessments. However, this does not mean that they will tend to disappear in the future. On the contrary, people will be increasingly relying on them. Transparent and robust data is on the rise leading to ESG ratings being used among other criteria in an ESG integration process.

### 2.2.4. International coalitions for sustainable investing

In recent years many coalitions for sustainable investing have surged. The best known are the Principles for Responsible Investments (PRI), the Global Impact Investing Network (GIIN), the Equator Principles and the Global Alliance for Banking on Values (GABV).

Within the framework of the research question, the focus is on the first coalition and its more material approach in terms of AuM[8]. Nowadays, the PRI initiative is probably the most extended network assembling sustainable investors globally. As mentioned in the introductory chapter, the idea behind UN PRI is to create the baselines for responsible investment (PRI, 2019). By signing and thus joining the coalition, financial institutions and investors are willing to enhance sustainable investment practices. The signatories are committed to follow a set of six principles, and receive advices on possible actions they could undertake (*cfr*. Appendix III. ).

In this initiative, ESG ratings have long been a controversial subject, in a sense that the PRI wishes to integrate the CRAs in the discussion with the investors (Cash, 2018). Though the opinion of both investors and CRAs regarding ratings might look divergent, one of the aims of the PRI is "to enhance the *systematic* and *transparent* consideration of ESG issues in the assessment of the creditworthiness of borrowers in fixed income (FI) markets" (PRI, 2017). CRAs should consequently be on board.

[8] Asset under Management.

Albeit their entering in the responsible finance movement, signatory investors stay cautious in the integration of CRAs in the discussion (Cash, 2018). Amid converging concerns about the manifest link between ESG issues and creditworthiness of a borrower, the role of PRI is to try finding a middle ground between both parties.

The underlying motivations of investors as well as the main sustainable investing coalition having been discussed, we should now take an in-depth look into one of the most important stakeholders in sustainable development: the business side.

## Section 2.3. Companies in the lookout for ESG ratings

Starting with a definition, externalities "refer to situations when the effect of production or consumption of goods and services imposes costs or benefits on others which are not reflected in the prices charged for the goods and services being provided" (OECD, 2002). In the neoclassical financial models, social and environmental externalities were not taken into consideration. The core purpose of companies was to produce optimally, to sell extensively and to make profits. The perspective has changed over time. To contribute to sustainable development, companies should be taking care of their negative externalities, and foster positive externalities on society.

In this regard, companies have a role to play in internalizing the negative externalities they produce, and should warn their investors about their most material issues, by self-reporting on it. Indeed, materiality – being the most significant impacts – is a crucial element to be put forward, saying that water consumption for an airline company is not as material as $CO_2$ emissions for example.

By fostering sustainability demand, responsible investors may incentivize companies to act upon their most material ESG issues, and this includes improving the key elements impacting the company's ESG rating. In this context, the business side should be part of the discussion. Indeed, their actions related to ESG and the resultant disclosures enable scoring providers to assess the company.

Khan, Serafeim and Yoon (2016) studied the existing link between material sustainability criteria and financial performances. They found out that there was a correlation between the companies that did well on material issues and their performances in terms of profits. Another study provided results on the link between CSR[9] and credit ratings (Jiraporn, Jiraporn, Boeprasert, & Chang, 2013). It concluded that the effect of enhanced ESG performances and its ability to lower risks is reflected in a better credit rating compared to peers.

Yet, the source of the problem is the lack of international consensus about how to interpret a company performance . At a governmental level, a European Directive (2014/95/EU) requires a non-financial disclosure from large companies (more than 500 employees), in order to understand the ESG state of a company (Directorate-General for Financial Stability, Financial Services and Capital Markets Union, 2015). However, a commonly accepted disclosure framework, for all companies and regions, has not been put in place yet.

As reporting on business sustainability status is crucial for ESG ratings providers, as the first step in the scoring process (*cfr*. Chapter 3), a general consensus is rising in the field of sustainable finance. It is deemed that disclosures are the crux of sustainable ratings. Indeed, among the GRI – Global Reporting Initiative –, the SASB – Sustainability Accounting Standards Board – or the TCFD – Task Force on Climate-related Financial Disclosures, just to mention few, how are companies able to choose the right reporting method? Companies as much as investors feel overwhelmed. According to a McKinsey & Company report, based on a survey of 107 executives and investors from Asia, Europe and the United States (2019), “many investors believe that harmonized sustainability-reporting standards will attract more capital to sustainable investors […]”. Against this background, we should consider the leading reporting frameworks. The SASB, GRI and TCFD are the main players in this industry. The SDGs are often used as a reporting means, but will not be described in this section.

Starting with the GRI, its main principle is laid down by stakeholders inclusiveness. Those reporting standards are complementary to integrated reporting, in a sense that they focus more on material sustainability issues (environmental, social and governance) for society in general (Schoenmaker & Schramade, 2018). The added value of GRI is that it allows a smooth

[9] Corporate Social Responsibility.

comparison between various companies, and it aims at enhancing the dialogue with stakeholders.

As for the Financial Stability Board, established by the G20, it created the TCFD in 2015. This framework helps companies performing stress testing as well as scenario thinking. As its name suggests, the TCFD is only focused on a climate-related risk and opportunities perspective. This framework encourages companies to disclose according to guidelines which are aligned with investors' needs (TCFD, 2019).

Concerning SASB, it has been developed for both public companies and investors. It was developed in 2011, and as of 2018, the initiative has set industry-specific sustainable accounting standards, with metrics as well as recommendations (Schoenmaker & Schramade, 2018). Because the reporting burden of GRI was worrisome for companies, the SASB emerges more appealing (Temple-West, 2019). The main strength of SASB, compared to GRI, is its ability to foster disclosures on the most material sustainable issues of a company, and not the entire spectrum of materiality for society.

As a conclusion, it is tremendously overwhelming for both companies and investors to understand which framework is more suitable to their needs. In January 2020, during the World Economic Forum, an announcement from the Big Four accounting firms and CEOs of the largest companies caused quite a stir. As a matter of fact, they are planning to develop a new harmonized framework including generally accepted principles about non-financial reporting standards (Tett, Nauman, & Edgecliffe-Johnson, 2020).

## Section 2.4. The European vision of sustainable finance and ESG ratings

In the frame of long-term value creation (*cfr*. **Figure 1**), governments play a crucial role in the loop, by its inherent relation with the financial system, preserving financial, environmental and social capital in the long run.

This work being written on the Old Continent, the focus will be on this geographical area "The European Union is committed to becoming the first climate-neutral bloc in the world by 2050" (European Commission, 2020a). This straightforward statement embodies the European Green Deal, announced after the election of Ursula von der Leyen as the head of the

European Commission (EC) in December 2019. Since 2016, the European Commission has been working on a taxonomy which fosters the development of sustainable investing guidelines, in line with the UN 2030 Agenda and the 2015 Paris Climate Agreement (European Commission, 2020b). “The EU Taxonomy is a classification tool to help investors and companies identify environmentally friendly economic activities” (EU Technical Expert Group on Sustainable Finance, 2019a). The EU Taxonomy is better known as the EU Action Plan, following recommendations by the EU High-Level Expert Group on Sustainable Finance.

Within this EU sustainable finance strategy, the key question in this thesis is to understand how the EC considers and values sustainability ratings? The intermediary taxonomy reports, respectively dated January 2019 (concerning disclosures) and June 2019 (regarding technical reports) mentioned sustainable ratings only once. The enhancement of climate-related disclosures is encouraged to improve the credit ratings for bonds of listed companies. It is also said to be a benefit for the creditworthiness assessment of bank loans (EU Technical Expert Group on Sustainable Finance, 2019b).

The subject of “ESG ratings” specifically has recently come under great scrutiny. In December 2019, the London Think-tank SustainAbility was appointed by the EC to develop a study on sustainability ratings and research, serving the objective, among others, to “provide a state of play of the sustainability-related products and services market” (Ted. tenders electronic daily Europa, 2019). The results of this study will be made public in the fall 2020 and should be closely followed. In a recent working document related to the Green Deal, the EC is undertaking a public consultation, and questions on sustainable ratings are arising (Directorate-General for Financial Stability, Financial Services and Capital Markets Union, 2020). Some sample questions are:

- Do you have concerns on the level of concentration in the market for ESG ratings and data?
- How would you rate the comparability, quality and reliability of ESG data from sustainability providers currently available on the market?
- How would you rate the quality and relevance of ESG research material currently available on the market?

This thesis will not cover all the above questions, yet it may help laying the foundations of the sustainable ratings market. Concerns over the present ESG ratings state of play are arising, as investors will be increasingly relying on those financial products in the near future. As a consequence, the EC might make further decisions regarding sustainability ratings and the main players on this market.

One of the main points of criticism of these ratings by the EC is that “Specialist providers and in-house providers are offering different methodologies, which results in a lack of comparable, reliable and clear results” (van Scherpenzeel, 2020). The emerging concerns express the need to further explore the different methodologies utilized by the main players in ESG ratings. This will be the core theme of the following chapter.

# Chapter 3 Rating providers : landscape and methodologies

This chapter is crucial in building an appropriate answer to the research question: *What is the value of ESG ratings for responsible investors in allocating capital towards sustainable companies?* Understanding how ESG ratings are established, as well as their subjacent methodologies, will help us in the process of assessing the differing outcomes from various ESG scoring providers, which are SRAs, CRAs, financial information platforms and sustainable indices. This third chapter does not expand further the methodologies used for in-house ratings, because of the conceptualization complexity of ESG in each stakeholder's perspective. Chapter 3 will rather feature a critical assessment – namely a comparison – of ESG ratings.

## Section 3.1. Dynamics of the ESG rating and research landscape

Over the past few years, an increasing number of consolidations has flourished on the ESG rating market. The status quo of this market has been described in the appendices (*cfr*. Appendix IV. ), which one should read in parallel with this section. This overview has been assembled based on the main players on this market, showcased by several scholars (Huber & Comstock, 2017; Berg, Koelbel, & Rigobon, 2019; Escrig-Olmedo, Fernández-Izquierdo, Ferrero-Ferrero, Rivera-Lirio, & Muñoz-Torres, 2019) and the think tank SustainAbility (Wong, Brackley, & Petroy, 2019).

The ESG ratings and research landscape is constantly changing and evolving. Indeed, a tremendous amount of mergers and acquisitions carved the competitive environment. For example, Trucost was famously known for its "cost-effective tool to measure the carbon and environmental footprints of companies using its unique, comprehensive database of the resource use and emissions of over 4,000 listed companies" (Monks & Lajoux, 2011). In October 2016, this SRA was acquired by Standard and Poor's to enhance its ESG offer (Cash, 2018). Standard & Poor's was also cited in the news during the writing of this paper, due to its memorable acquisition of the ESG ratings arms of RobecoSAM, the SRA branch of the Swiss investment specialist (The Economist, 2019). This demonstrates the constant dynamism within this market.

Another example is Morgan Stanley purchasing in 2010 RiskMetrics, which itself acquired KLD (Kinder, Lydenberg, Domini Research & Analytics), providing assessment tools on ESG issues. Following the Financial Crisis and the woefully famous Deepwater Horizon Oil Spill, MSCI – Morgan Stanley Capital International – a spin-off of its parent company, was developed. Through the incorporation of RiskMetrics, MSCI ESG Research was able to provide risk and ESG scores (Cash, 2018). When MSCI ESG Research bought KLD in 2010, it acquired a set of companies, among which was ISS. However, MSCI sold ISS in 2014 to Vestar Capital Partners (Eccles & Stroehle, 2018).

As far as Moody's is concerned, the firm managed to cause quite a stir in 2019 by its purchase of a majority stake within Vigeo Eiris, "one of the most prominent European ESG research outfits, which traces its roots back to the beginning of the socially responsible investing movement in the early 1980s" (Nauman, 2019).

To conclude, one should also keep in mind that depicting a simple picture of the ESG ratings market and dividing third parties in various categories turns out to be more complex than it looks like, which is why some may find this separation arguable. However, this work aims at representing above all the discrepancies between the main third parties, bearing in mind that categorization is far from being simple. With the stream of mergers and acquisitions which defines this market, the distinction between each category is confusing. A concrete example will illustrate this situation. FTSE Russel, initially an index provider, is fully owned by the London Stock Exchange Group (LSEG). For years, FTSE Russel has partnered with the French SRA Beyond Ratings to provide sustainability indices. In 2019, Beyond Ratings was acquired by LSEG, offering a comprehensive set of sustainability data. In August of the same year, Refinitiv was set to be acquired by LSEG as well (Massoudi, 2019). Those acquisitions lead to a full set of ESG expertise, with an SRA, an investor channel, and an index provider.

## Section 3.2. Sustainable rating agencies

In recent years, growing interest in ESG issues has been witnessed, whether in the form of sustainable reporting from companies, or of an emergence of ESG data. The sustainable rating agencies form part of this movement, and as of 2016, we accounted more than 100 ESG rating agencies, delivering sustainability data and scoring (Amel-Zadeh & Serafeim, 2017).

As previously mentioned in the first chapter, each of those agencies has developed their own assessments of the status quo of sustainability within a company. In order to do that, various methodologies are used, and the final evaluation is presented in the form of a rating opinion.

We should again state that some sustainable rating agencies are fundamentally different, in the sense that some are topic-focused, while others are comprehensive. This means that they are based respectively on either a strong expertise on a specific ESG issue, or on a broad expertise expressed by means of a general sustainability score. The following Table 2 compares SRAs on key indicators, and summarizes the results obtained in the coming description of each studied agency.

| | *Focus* | *Coverage* | *Data Sources* | *Key issues identified* | *Rating scale* |
|---|---|---|---|---|---|
| *MSCI ESG Ratings* | - Company assessment<br>- Industry and peer-based comparison<br>- ESG risks and opportunities<br>- Industry-based materiality<br>- *Comprehensive* | + 7,500 companies worldwide<br>+ 200 analysts | Analyst-driven, from:<br>- Company disclosures<br>- Public & NGO reports<br>- Controversies | 37 ESG key issues | AAA to CCC |
| *Sustainalytics* | - Company reports<br>- Peer-based comparison<br>- ESG risk and opportunities<br>- Financial-based materiality<br>- *Comprehensive* | + 11,000 companies worldwide<br>+ 180 analysts | Analyst-driven, from:<br>- Company disclosures<br>- Public and NGO reports<br>- News and controversies | 40 material indicators | 0 to 100<br>(0 = lowest risk-level) |
| *RobecoSAM Ratings* | - Corporate Sustainability Assessment for the DJSI<br>- Investors-based materiality<br>- *Comprehensive* | + 4,500 listed companies worldwide | Questionnaire-driven:<br>Industry-specific questionnaire | Survey | Gold, Silver, Bronze |
| *ISS ESG* | - Company assessment on a best-in-class basis<br>- Sector-specific and materiality- focused approach<br>- *Comprehensive* | + 10,000 companies worldwide<br>+ 200 research analysts | Analyst-driven, from:<br>- Public reports<br>- Media<br>- Stakeholders' interviews | 100 indicators, with<br>5 industry-specific issues | A+ to D- |
| *CDP* | Company assessment on climate change, water security and forest<br>- *Topic-focused* | + 8,400 companies | Questionnaire-driven | 175 indicators | A to F (or D-) |

***Table 2*** *Comparison of the explored sustainable rating agencies.*

Compared to the CRAs, we highlighted before that SRAs scorings were rather requested by asset or fund managers, as well as index builders. This tremendous difference in comparison with the "issuer-pays model" brings to the fore a main difference with credit rating agencies. This might be seen as a great advantage, as it could eliminate a conflict of interest arising when the companies themselves are paying for the rating (Cripps, 2019).

This section will highlight the various methodologies and concrete applications developed by the largest and most renowned sustainable rating agencies, according to several prominent papers (Berg, Koelbel, & Rigobon, 2019; Amel-Zadeh & Serafeim, 2017; Huber & Comstock, 2017). Our aim will be to comprehend their methodology, how they funnel the data into their approach and its provenance, and how materiality is considered within each of the opinions.

### 3.2.1. MSCI ESG Ratings

By April 2017, MSCI ESG Research (launched in 2010) was the largest ESG data and research provider by clients numbers in comparison to other agencies, such as Sustainalytics, Oekom (acquired by ISS), and Vigeo Eiris (MSCI ESG Research, 2018). The purpose of MSCI ESG Ratings is to measure a company's sustainability over the lifespan of its underlying assets (MSCI ESG Research LLC, 2019). According to their website, by October 2019, MSCI has, rated "7,500 companies (13,500 issuers including subsidiaries) and more than 650,000 equity and fixed income securities globally" (MSCI ESG Research LLC, 2019).

The MSCI rating methodology is fuelled by data coming from company disclosures (financial and sustainability), governmental reports, NGOs and academic databases, and an on-going review of controversies and/or issues that might affect the company or the industry as a whole. In a first phase, more than 200 analysts measure to what extent the company is exposed to an ESG issue. In a second phase, the management response to this issue is assessed. The ESG model takes into account those material issues, specific to each industry, following the 37 ESG key issues identified. A weighted average score is provided, and the key scores are then aggregated to form one comprehensive assessment. This score will enable to provide an adjusted rating relative to industry peers, leading to the final 'AAA' to 'CCC' ESG Rating.

This ESG rating agency also mentions that they continuously review and monitor the company, and update the scoring if necessary. They also give the possibility to the company to engage in a dialogue with them, in order to verify the ESG data accuracy.

MSCI eventually designs a "tear sheet", presenting an exhaustive view of the company's risks and opportunities related to several issues and controversies faced in the past. They also deliver a free online tool which displays an overview of most companies score and the reasoning behind it. The results are said to be industry and peer-based, and investors should interpret it in that way.

### 3.2.2. Sustainalytics

Sustainalytics provides sustainability insights both from investors and companies requests, covering more than 11,000 companies from over 139 sub-industry classifications (Sustainalytics, 2020b). This ESG rating agency results from a consolidation in 2009 between the Dutch Sustainability Research, the German Scoris, and the Spanish AIS. In 2019, Sustainalytics acquires GES International, a corporate governance specialist (Sustainalytics, 2020a). The rating provider was fully acquired by Morningstar, a global financial services provider, in April 2020 (Morningstar, 2020). Before that, Morningstar was in possession of 40% of ownership stake.

This SRA provides ESG risk ratings, recognized as the "next generation of ESG ratings" (Sustainalytics, 2020b), a recent change of term. These sustainability scores aim at comprehensively integrate the ESG concerns which are financially material.

Within their methodology (Sustainalytics, 2020b), Sustainalytics' 180 research analysts first feed data from annual reports, news, NGOs, governmental documentation, GRI, etc. They then assess the various indicators that are industry-specific. They cover more than 70 indicators throughout all industries, providing dedicated weights according to their importance (Huber & Comstock, 2017). Their assessment is divided in three core building blocks, which are "corporate governance, material ESG issues and idiosyncratic issues" (Sustainalytics, 2020b). Each industry has approximately 40 material indicators, assessed on three pillars (preparedness, disclosure and qualitative and quantitative performance).

The key ESG issue is then placed on a two-dimensional materiality matrix, derived from material indicators from the sector and the exposure mitigation of the firm. A final score from 0 to 100 is attributed in the end, 0 being the lowest risk-level. This scale is divided into 5 categories: negligible, low, medium, high and severe. The ESG research is the baseline for the ESG risk rating. It is provided in the form of a report where each company performances are compared to peers. As part of an annual update of the scoring, companies are contacted and have the chance to provide feedback on their ESG report. Engagement from companies is welcome at any time.

### 3.2.3. RobecoSAM Ratings

As a sustainable investment specialist, RobecoSAM has developed its own corporate ratings. The ESG scoring arm of this Swiss firm was sold to Standard & Poor's in January 2020 (The Economist, 2019). Before that, S&P had partnered with this rating agency to develop the DJSI – Dow Jones Sustainability Indices (further investigated in the indices section) in 1999 (Huber & Comstock, 2017). In a recent study by the think-tank SustainAbility resulting from a global survey, RobecoSAM is deemed to lead on "quality and usefulness" of ratings (Wong, Brackley, & Petroy, 2019).

RobecoSAM displays each year its Corporate Sustainability Assessment (CSA) of the best performing listed companies in the world in terms of monitoring sustainability risks and opportunities related to industry (RobecoSAM AG, 2018). Analysts start off their research by performing a materiality matrix, where sustainability concerns might arise and have direct impacts on financial performances. Indeed, RobecoSAM's materiality conception focuses on taking the perspective of one stakeholder: the investor (GRI and RobecoSAM, 2015). An industry-specific questionnaire is sent annually to the most prominent listed entities worldwide, subsequently identifying companies which are considered outperforming in terms of sustainability. In those questionnaires the relative importance of each criteria (economic, environmental, social) may vary drastically from one sector to another. An issue raised by the authors of "Aggregate Confusion: The Divergence of ESG Ratings" is that if companies don't reply to the questionnaire in full, then it results in a bad rating for unanswered questions (Berg, Koelbel, & Rigobon, 2019).

The CSA questions are given a score from 0-100, and are supplemented by a Media and Stakeholder Analysis (MSA), as well as a cross-checking procedure with publicly available information (reports and datasets). The CSA is the backbone of the development of the Dow Jones Sustainability Indices (World and Regional indices), giving a Gold, Silver or Bronze label to included companies.

### 3.2.4. ISS ESG

ISS (Institutional Shareholder Services) ESG comprises ISS ethix, ISS climate and ISS oekom. In 2015, ISS acquired the Swedish Ethix SRI advisors, demonstrating its intention to specialize in ESG ratings (Huber & Comstock, 2017). In 2018 it acquired Oekom, specialized since 2002 in corporate responsible ratings (Eccles & Stroehle, 2018). ISS offers services to institutional investors, helping them to integrate responsible investment practices. It also provides climate change data.

ISS ESG provides a large set of services, from advisory services, climate solutions, ESG ratings and rankings, etc. In order to issue company ratings, 200 analysts take the data for their ratings from public reports, media and discuss with stakeholders (ISS, 2019). More than 800 indicators are taken into account, and 90% of them are industry-specific. Within each industry, five key elements represent more than half of the final rating. Every E, S and G criteria are weighted according to industry-specific issues. Their granular methodology provides a score ranging from A+ to D-, where A+ is an indicator of excellent sustainable performances (ISS ESG, 2020), on more than 10,000 issuers (ISS, 2019).

In 2017, with the collaboration of CDP (*cfr.* below), it launched the very first climate impact rating, called Climetrics (Huber & Comstock, 2017). Investors becoming worrisome about environmental issues, this tool offers a simple way to make climate-friendly investments. ISS is also recognized for its alliance with the SASB standards (ISS ESG, 2020).

### 3.2.5. CDP

CDP, formerly recognized as the Carbon Disclosure Project, “runs the global environmental disclosure system” (CDP, 2020). In November each year, this non-for-profit firm assesses the responsiveness of firms regarding the CDP, by evaluating the soundness and comprehensiveness of data provided by companies (Huber & Comstock, 2017). It is not in itself a sustainable rating agency, as CDP is known as an NGO, however we will consider as such for the sake of research.

The methodology works as follow: after stakeholders of a firm request the CDP score of a company, a questionnaire is sent out to the firm. Answers are then analyzed in terms of climate change, water security and forest, through 175 indicators. The final scores, ranging from A to F (or D-), are given on climate change, water security and forest dimensions (CDP, 2019). This score "is a metric of good internal management, an understanding of climate change issues and company transparency on climate change" (Huber & Comstock, 2017).

## Section 3.3. Credit rating agencies

This section will examine the current state of ESG integration in the assessment of creditworthiness of a borrower, in other words, how credit rating agencies incorporate the environmental, social and governance criteria into their rating methodology. It will browse the three leading American CRAs, which are Standard & Poor's (S&P), Moody's and Fitch Ratings. Even though the US accounts ten recognized statistical ratings organizations, the top three carry out 98% of all the ratings (Stubbs & Rogers, 2012).

In traditional credit ratings, companies are evaluated on risks which represent their default likelihood and their financial health. The common perspective of CRAs on sustainable issues is that if the ESG dimension has a direct and demonstrated impact on creditworthiness, then it will be captured in the rating. Integrating sustainability in lending should be understood differently than in equity investing, as the focus is more on the risk side than the opportunity side. Indeed, fixed income investors are not as much involved in firm governance, and barely benefit from upside price potential, as equity investors do (Schoenmaker & Schramade, 2018).

As this section aims at understanding ESG considerations coming from CRAs, we shall now review and assess their value within the rating process of each of the three leading agencies.

### 3.3.1. Standard & Poor's

S&P was one of the first agency to become a signatory of the PRI, in April 2012. The rating provider defines "ESG credit factors as environmental, social, or governance factors that influence the capacity and willingness of an obligor to meet its financial commitments" (Kenan

& et al., 2019). PG&E, an energy provider in California, had aroused American's indignation when the transmission grid the company was managing caused a tragic fire in 2017, one of the deadliest in the state's history.

For this CRA, the concept of materiality is key within ESG considerations in the rating process. Indeed, they believe that some industries, sorts of assets, or capital structures might suffer from sustainability issues to a variable extent. Up to a certain point, they are transparent about their ESG considerations. Indeed, they state that a "strong creditworthiness does not necessarily correlate with strong ESG credentials" (Kenan & et al., 2019). Recently, Standard and Poor's has launched the S&P Global Ratings Green Evaluation, which aims at providing a second party opinion regarding the reliance on the Green Bond Principles (S&P, 2020). This rating may take place on any type of financing, and delivers a more comprehensive view of the environmental impacts faced.

In conclusion, as demonstrated by the recent purchase of the ESG ratings branch of RobecoSAM (The Economist, 2019), there is a growing evidence that S&P is building incrementally better expertise on the ESG factors, and in particular on the 'E'.

#### 3.3.2. Moody's

Moody's Corporation, in terms of its commitment to the Principles, is considered as a late mover. Indeed, the firm only signed the PRI in July 2019 (Schwartz & Adler, 2019). The firm has previously drafted an important report about ESG considerations within its rating processes. In this report, Moody's announces that their "objective is not to capture all considerations that may be labelled green, sustainable or ethical, but rather those that have a material impact on credit quality".

Before stepping into the ESG integration in their credit rating, one should understand which methodologies are currently used by Moody's and how the inclusion of sustainability criteria was triggered. In this methodology, for environmental concerns (Stubbs & Rogers, 2012), Moody's incorporates ESG criteria and identifies two types of risks: physical risks (direct environmental hazard) and transition risks (impact towards (supra-)national regulations).

In February 2020, Moody's ESG analyst Ram Sri-Saravanapavaan declared in an interview for Environmental Finance that “one major trend is that climate change and the transition to a low-carbon economy are growing in relevance for global credit markets” (Lester, 2020). This might be linked to the 2019 ESG momentum amid escalating climate change concerns. He also stresses that transition risks for carbon-intensive industries should be increasingly considered, and that social issues such as aging population will have great impacts for the future.

In conclusion, we can affirm that Moody’s is adopting an ESG lens within its credit rating process if materiality is deemed fully-fledged.

### 3.3.3. Fitch Ratings

According to Daniel Cash (2018), Fitch Ratings has privileged different considerations about ESG integration amid the leading CRAs. Where S&P and Moody’s opted for a sustainable window dressing, Fitch remained quieter, and only released a six-pages report about its sustainability approach in 2017 (“Fitch Ratings Approach to Capturing [ESG]”). Fitch signed the UN PRI in September 2018 (Fitch Ratings, 2018). It was justified inter alia by the increasing interest of the financial community for ESG-related concerns.

Since 2018, Fitch’s major step towards sustainability considerations is the launch of an “ESG Relevance Score”, which shows to what extent ESG issues trigger a variation on credit (Fitch Ratings, 2019). This is the first CRA to systematically deliver an ESG assessment affecting the creditworthiness of an entity. Their aim with this brand-new tool is not to deliver an ESG score in itself, but rather to highlight the sustainability issues that are material to the credit rating decision. In comparison with SRA, they do not focus on giving a perception about how ‘good’ or ‘bad’ a company is doing in terms of sustainability.

## Section 3.4. Financial information platforms

The next ESG data providers vetted here are the financial information platforms, i.e. platforms offering integrated data and analysis about the financial market. The two main players are Bloomberg and Refinitv (formerly known as the Thomas Reuters Financial & Risk Business branch). These third party providers assess companies’ sustainability performances, offer raw

ESG data, and display other ESG ratings from different SRAs. They thus have a multifaceted role in ESG research and ratings, and offer multiple services to investors.

### 3.4.1. Bloomberg

Since its acquisition of New Energy Finance in 2009, Bloomberg has tremendously expanded its offer related to sustainable financial products (Huber & Comstock, 2017). From there, Bloomberg ESG Data Service was launched, providing the Bloomberg ESG Disclosure Scores. As its name indicates, it scores companies on the transparency of the ESG data publicly disclosed, scaling from 0 to 100. By gathering data about 11,500 companies (Bloomberg, 2019), the Bloomberg terminal has the means to develop a disclosure score based on an enormous set of data.

The data used within Bloomberg's methodology mostly comes from company-reported ESG data, coupled with websites, public sources and direct contacts with companies. The information received is carefully verified and standardized, with the help of Business Intelligence (BI) and Bloomberg New Energy Finance (BNEF), gathering 120 ESG criteria (Huber & Comstock, 2017). One should notice that the Bloomberg terminal also displays ESG ratings from other rating agencies, such as RobecoSAM, Sustainalytics, ISS Quality score, and CDP (retrieved from the Bloomberg Terminal).

### 3.4.2. Refinitiv

Refinitiv is still better known as Thomas Reuters, despite the fact that the Financial and Risk Business changed its name in 2018 (Reid, 2018). It is a provider of financial market data and infrastructure. In 2009, Thomas Reuters acquired ASSET4 to bolster its expertise in ESG offerings. Refinitiv methodology flows directly from the ASSET4 heritage, and has been further enhanced. Refinitiv publicly explains its ESGC (C standing for combined) and Controversy Scores methodology via annual reports (Refinitiv, 2020). The collection of data results from company reports, NGOs websites, stock exchange fillings, and company websites. Ten main themes are developed from over 450 ESG metrics for each company. Each of these ten categories is weighted following the number of issues each category represents. An ESG overall score is then provided. The final rating, from A+ to D-, is displayed on the "Eikon" platform: the ESG Score and the ESG Controversy score are available as two standalone scores.

## Section 3.5. Sustainability indices providers

A last third party provider category is generally relied upon to provide ESG ratings for investors: sustainability indices providers. There are numerous players in this category, but this work focuses mainly on categories most recognized by investors. This part does not include the indices provided by ESG rating agencies which were mentioned above, as the methodologies remain the same (e.g. MSCI ESG indices).

### 3.5.1. FTSE Russel

The sustainability indices provided incorporate ESG ratings developed by the FTSE Russell's ESG ratings and data model branch. Those scores consist of fourteen themes within the E, S and G pillars, based on an average of 125 indicators by company (FTSE Russel, 2020a). The themes represent exhaustively the 17 SDGs. The construction process of an ESG index is based on the market capitalization weighted indices, such as the Russel 1000 Index or the FTSE Developed Index. The ESG scores of the companies integrated in those indexes are standardized, and outliers are removed. Each market capitalization is weighed, tilting the weights according to the obtained ESG score. The sectorial influence is taken into account, by neutralizing the interference it may have on certain criteria compared to other sectors. While diversification of the "portfolio" should remain, companies not belonging to the sustainability universe covered by this index are removed. The index is monitored annually. The different steps to create sustainability indices come from the FTSE Russel Report : "FTSE ESG Index Series" (FTSE Russel, 2020a; PRI, 2020a).

### 3.5.2. Dow Jones Sustainability Indices

The Dow Jones Sustainability Indices (DJSI) was developed in 1999 and became pioneer in terms of sustainability-driven indices (Huber & Comstock, 2017). This family of indices holds DJSI World, DJSI Regions (DJSI North America, DJSI Europe and DJSI Asia Pacific), and DJSI Country (DJSI USA) (Escrig-Olmedo, Muñoz-Torres, & Fernández-Izquierdo, 2010). As previously mentioned, companies falling within these benchmarks outperform their peers in terms of sustainability, based on the CSA (Corporate Sustainability Assessment) of RobecoSAM, the rating agency. The public traded companies present in the annual CSA are potential candidates to be included in the family of DJSI. A certain percentage of the best preforming companies are kept to be included within the index. For instance, for DJSI Europe, "top 20% of the largest 600 European companies in the S&P Global BMI [Broad

Market Index]" are represented (Huber & Comstock, 2017). The score is provided on a scale from 0 to 100, and is displayed on RobecoSAM's website (now belonging to S&P).

## Section 3.6. Implications

Going back to the various methodologies used, each category of ESG data provider had similar approaches, but a distinction could be pointed out between CRAs' methodologies and the other categories. Indeed, credit ratings are not a stand-alone ESG score, but integrate sustainability issues within their processes, thus making the output completely different.

For the other categories, we could divide the methodologies into two subsets: the analysis-driven approach, and the questionnaire-driven approach. Finding reliable data to feed this chapter is challenging. Indeed, without being customers and having access to deeper documentation, we noted a lack of transparency, impeding to fully understand the particularities of the providers' methodologies. However, as Delmas & Blass mention (2010), rating methodologies are the bread and butter of providers, and a source of competitive advantage. Enhanced transparency would mean that they could lose some shares of the market by selling their "secret recipe". In another article, raters are criticized because they usually claim similar virtues (Chatterji, Durand, Levine, & Touboul, 2016). For instance, all SRAs ensure the high quality of data fed into their methodology, because they rely on various sources.

This chapter has led to another major observation, that is the growing relevance and use of data. As mentioned in the World Economic Forum Meeting in January 2020 (Craig), "sustainable finance starts with data". Even though this statement was pronounced by the CEO of Refinitv, numerous voices are rising in favour of it, notably in the media (Moral Money, Financial Times). In Artificial Intelligence and Big Data lies a current and future approach to data management, which will most certainly be used in the years to come in order to strengthen the basis for ESG ratings. Following this argument, many tools have popped out of the sustainable finance industry, among which we could mention 'TruValue Labs' as a relevant example (Serafeim, 2018). This service defines itself as the application of "AI to uncover opportunities and risks hidden in massive volumes of unstructured data, including real ESG behaviour that has a material impact on company value" (TruValue Labs, 2020). Even though this thesis will not analyse in depth this emerging type of business, our awareness was awakened, as it is a conceivable alternative to the previously mentioned data providers. With more time, it would have been interesting to dig deeper in that direction, in particular for private companies and in markets less well covered by the mentioned third parties.

# Chapter 4 Drawbacks and challenges of ESG ratings

As outlined in Chapter 3, ESG ratings may be provided by several players, helping investors choose a rule of thumb in their investment decision. It serves as a quick way to judge the sustainability profile of a company. The different methodologies may explain the sustainability scores limitations, but extensive research has proven that there is more to it. As a reminder, a weak correlation exists amongst ESG ratings. Moody's and Standard & Poor's offer credit scores correlated at 0.99, whereas a study comparing five ESG rating providers showed a correlation in the dataset ranging from 0.42 to 0.73 (Berg, Koelbel, & Rigobon, 2019).

As a concrete example, we can focus on Facebook. While Sustainalytics gives this social media company a score of 33 (on a 0-100 scale), signalling few unmanaged risks (Yahoo Finance, 2020), and while MSCI assesses it as average in its industry (MSCI ESG Ratings, 2020), Standard & Poor's took the decision to drop Facebook from the S&P 500 ESG index in 2019. Indeed, after the DJSI rated Facebook 21 out of 100 (which represents, in this case, a low ESG score), the company was rejected from the benchmark. As S&P's ESG rating partner, RobecoSAM discovered severe social and governance issues in 2019: "Media and Stakeholder (MSA) analysis found that Facebook had experienced many privacy issues over the past 24 months, including allowing more than 150 companies access to more users' personal data than it had disclosed, misuse of personal information (e.g., Cambridge Analytica) and hacking of almost 50 million accounts" (Steadman, 2019). This example shows the divergent results that may emerge from various providers.

The disruptive part of ESG ratings does not only come from its low convergence across providers, but also lies in the high performing scores of controversial industries, such as the oil and tobacco industries, whereas it would seem more pertinent that other sectors outperformed them in terms of their polluting history. Some credit analysts also highlight that highly polluting companies are able to get good ESG ratings due to measurements that favour firms with better disclosure standards (Poh, 2019).

As an estimated $30 trillion of assets (Berg, Koelbel, & Rigobon, 2019) are invested with the help of ESG ratings, it is crucial to assess their value and implied drawbacks. In line with the latter, this chapter will contribute to the core of the research question. A robust review of the literature on ESG ratings criticism will draw conclusions about their assessment and their perception in the sustainable finance community. The limitations of ratings will be analysed in general terms for the mentioned providers. However, different categories (SRAs, CRAs, sustainable indices and financial information platforms) will not be compared. This part will be broken down following the main controversies occurring in the way sustainable scorings are built, from the input to the output and its final outcomes.

## Section 4.1. Data provenance

In its ‘Power from Statistics’ report from 2018, Eurostat determined that the topic of sustainable development was one of the most relevant to citizens and discussed how enhancing official data for this topic could trigger a better delivery of results (Khadraoui, 2018). In the subsection called “Data and sustainable finance: how data disclosure could redirect investment towards the economy of tomorrow”, the author, Saïd El Khadraoui, recognizes the significant role played by sustainable finance in enabling the well-being of present and future generations. He also highlights the need for common definitions and high-quality data to effectively allocate capital from unsustainable to future-proof companies. This change should be fostered by improving the sources of data and by reflecting on non-financial disclosures requirements at governmental level.

Along the same vein, the argument on the lack of standardization is put forward by many authors and stakeholders of the sustainable finance community. Amir Amel-Zadeh and George Serafeim (2017) state that the lack of reporting standards is the main obstacle to ESG data integration. Indeed, sustainable reports remain more qualitative than quantitative, as it is criticized in the Working Paper by MIT Sloan School of Management (Berg, Koelbel, & Rigobon, 2019). It is pointed out as a crucial difference compared to financial reporting, which has been highly standardized for more than a century. Therefore, this gives a large spectrum of discretion for ESG raters to produce a final rating for the same company, or to compare companies from the same sector. Some differences in ESG ratings may also appear in a geographical perspective. A study (Chatterji, Durand, Levine, & Touboul, 2016) suggests that ratings might be influenced by providers’ country of origin. It emerges that European companies are incentivized to establish sustainability reports (Hawley, 2017), while it might not be the case in other parts of the world.

As long as firms are not required to produce non-financial disclosures, there will be discrepancies in ESG ratings. Regulators do not stipulate specific sustainable standards and data such as financial reporting and this leads to inconsistencies. This lack of consistency among companies' sustainability reports will remain a key challenge in the long-term perspective of eventually collecting high-quality and comprehensive data. At EU level, several initiatives are underway. For instance, pension funds are now required to take into account ESG criteria while investing, the Shareholders Rights Directive obliges businesses and investors to disclose on ESG factors and the Directive on the disclosure of non-financial information has been launched as well (Khadraoui, 2018). However, this mentality still needs to be generally adopted by all sectors and organisations and we certainly are a long way from there.

In order to offset such headwinds, investors are asking for an IFRS[10] of non-financial disclosures. Some even ask for industry-specific ESG data and scores tailored to sector specifications (Amel-Zadeh & Serafeim, 2017), which will be further explained in the forthcoming section. Among authors, some reckon that ESG rating agencies should offer more transparency by sharing the data used for measuring unique indicators, and by adopting a common methodology for final score aggregation (Berg, Koelbel, & Rigobon, 2019). Not only there is a need for standardized sustainability reports, but also for standardized ESG rating providers' methodologies.

Criticism on data management equally points out that it becomes stale on the long term. According to a combined research from an asset manager and a European hub for research on sustainable investing (NN Investment Partners and European Centre for Corporate Engagement, 2016), ESG scores show a very low variation over time, due to a longer-term orientation compared to financial ratings. Thanks to a recently acquired awareness, a new kind of ESG raters are emerging: they display and produce ESG data on a more frequent basis. George Serafeim illustrates for instance TruValue Labs, which "provides sentiment data on companies' ESG performance" (Serafeim, 2018) and is used by many investors nowadays.

[10] International Financing Reporting Standards.

Through SASB (*cfr.* Section 2.3), TruValue Labs takes advantage of artificial intelligence and algorithms to give an opinion about sustainability levels of a company, on a timely manner.

On a different note, the Big Four auditing firms (i.e. KPMG, Deloitte, EY and PwC) prove that they have a say in offering alternative solutions to the lack of standardization. They provide brand new services for companies, by auditing their sustainability reports not on the basis of financial standards, but rather on sustainability criteria. This alternative seems to offer better credibility to firms and delivers a sense of the soundness of their own report. ESG rating providers may use this solution to enhance the data they are collecting directly from corporations.

## Section 4.2. Materiality of factors: stakeholders' preferences

In the field of sustainable finance, the topic of materiality is high on the agenda. Indeed, each investor has preferences and weights importance of sustainability indicators accordingly. Conscious investors are not requisitely homogeneous and show various levels of sensitivity about sustainability issues (Rivera-Lirio, Munoz-Torres, Escrig-Olmedo, & Angeles, 2017). To factor this in, let us bear in mind that a single ESG score is proving to be tremendously challenging for raters. As extensively discussed in previous sections, even though the environmental indicator seems the most mainstreamed in general, social and governance criteria appear just as material for certain investors. For instance, anti-money laundering (AML) falls within one of the main concerns in the banking industry, where GHG emissions are less relevant, as banks are not directly polluting themselves.

Some investors give credit to companies which are doing better than their peers, while some others want to get rid of companies which are harmful in terms of several indicators. As mentioned in the previous section, sector-specific ratings might step in and complement general ESG ratings. A prevailing point of criticism in the literature denounces the sector neutrality still characterizing some scores. However, some discrepancies in the final ESG mark of the same firm might be explained because different providers are appealing to different group of investors (Chatterji, Durand, Levine, & Touboul, 2016). A solution is found in the SASB framework, which provides relevant insight about the materiality of ESG concerns within each sector. If ESG rating agencies are transparent in the way they are measuring sustainability levels, investors would then be able to measure sentiment on ESG performances with the materiality taxonomy.

A research worth being mentioned (Khan, Serafeim, & Yoon, 2016) has proved that firms which deliver good sustainability credentials in terms of material issues outperform firms which deliver good sustainability credentials in terms of immaterial issues. This means that investors should be most likely willing to gain ESG insight from rating providers which integrate materiality in their methodology.

## Section 4.3. Firm size bias

While assessing ESG ratings methodologies, some authors discovered that the firm size is influencing the final score when raters are performing an analysis. In the literature, various factors may explain this argument.

Chauhan observes that expenditure on sustainability-related costs is higher for multinationals than for smaller firms (Chauhan, 2014). This implies a first evidence of an existing abyss between ESG reporting in smaller and larger firms. Another finding underlines that smaller firms tend to disclose information in a more informal way (Baumann-Pauly, Wickert, Spence, & Scherer, 2013), where bigger ones have more dedicated communication paths. Other authors confirm the hypothesis of a correlation between ESG disclosures and company size (Hahn & Kühnen, 2013).

More recently, Drempetic, Klein & Zwergel (2019) suggest that ESG scores give a distorted picture of the genuine sustainability performances of a company, which is largely correlated with firm size. The larger the company, the more quality, resources and time can be allocated to ESG reporting. This provides an enhanced baseline for ESG rating providers in their analysis, because it enables them to have access to more accurate sets of ESG data. The authors even hint that if companies are only interested in getting a better score, they should invest in sustainability reporting rather than in truly improving their sustainability performances. This may happen, even though it seems to contradict the results intended by ESG ratings providers. Consequently, conscious investors should be careful when integrating ESG ratings in their investment decisions, as this may lead to counter intuitive results, not reducing the asymmetrical distribution of sustainability levels.

Firm size biases in ESG scores are confirmed by NN Investment Partners and ECCE's study (2016), whose conclusion is that "standard ESG ratings/scores typically used in equity selection tend to be higher for larger companies […]". This study also suggests that investors should tread lightly in using ESG marks in their portfolio. An MSCI Research also supports that larger firms tend to get better sustainability scores (Melas, Nagy, & Kulkarni, 2016).

## Section 4.4. Surface analysis

Another point of criticism from Schoenmaker and Schramade (2018) refers to the fact that third parties only scratch the surface of sustainability concerns. Indeed, for an analyst-driven approach, analysts often need to cover a large amount of companies. This shows the lack of proper means to understand the intricacy that may exists within firms.

## Section 4.5. Discrepancy in ratings: methodologies and final score

This section will tackle the variability in ESG scores due to the differing methodologies or models applied by the providers. Before stepping into that dimension, we should stress a first source of confusion for investors, which is the scaling of the ratings. Indeed, differently from CRAs – which have a comparable credit rating scale –, some ESG rating providers deliver heterogenous ones (*cfr*. examples in Table 2). For instance, where Bloomberg ESG Data Service offers a scaling range of 0-100, MSCI scales as AAA to CCC and Refinitiv assesses through both percentages and letter grades from A+ to D-.

The divergence in rating shows the subjective nature of defining sustainability and the materiality of ESG categories. Regarding the sources of discrepancy, a fairly recent research paper from the MIT Sloan School of Management outlines the "Aggregate Confusion" for investors and companies towards the disagreement in scores provided by ESG rating agencies (Berg, Koelbel, & Rigobon, 2019). In August 2019, the authors depicted a portrait of the situation in the ESG ratings providers community underlining the fuzziness of their scoring methodologies. They highlight three sources of discrepancy, which are:

- *Scope divergence* – in selecting the sets of material categories. Where some rating agencies may take into account the impact on biodiversity, others would focus on lobbying issues;

- *Weight divergence* – in giving importance to each ESG category. Some SRAs might give more prominence to GHG emission, whereas others attribute more weight to governance issues in the final computation;
- *Measurement divergence* – in measuring the same ESG criteria, rating agencies might use different indicators to explain the same attribute.

The study outlined that the source of divergence with the largest impact on the discrepancies is the measurement divergence, which explains fifty percent of the differences. This is confirmed by other studies on the convergence of firms' ratings (Chatterji, Durand, Levine, & Touboul, 2016). ESG rating agencies might compare themselves to financial analysts, by undertaking surveys and by reviewing official government data, firms' sustainability reports and press releases, however they use different proxies to measure the same ESG indicators. For example, gender diversity might be based on the percentage of women on the board of Directors, the gender-pay gap or the percentage of women holding a managerial position (Berg, Koelbel, & Rigobon, 2019).

The MIT paper also found a relatively important 'Rater effect', i.e. "the rating agencies' assessment in individual categories seems to be influenced by their view of the analysed company as a whole" (Berg, Koelbel, & Rigobon, 2019). Reinforcing our previous argument towards the subjectivity of corporate ESG performances, this proves that SRAs have a tendency to detect good performances in all categories once good performances have been detected in one category.

## Section 4.6. Pitfalls and implications

In this concluding section, we shall recall the consequences that ESG ratings discrepancies imply for companies and investors. Indeed, some measures should be taken to address hurdles in interpreting ESG scoring in sustainability credentials for firms, or in investment decision-making for investors.

The think-tank SustainAbility suggested in a recent study that firms are struggling to understand how and where to spend time and resources to improve their sustainability outlook (Wong, Brackley, & Petroy, 2019). Indeed, it appears confusing for companies to grasp how they are perceived by ESG ratings providers. Along the analysis process, the subjectivity of this sustainable finance tool may lead to great frustration for firms. According to the authors of the MIT Sloan Research Paper, ESG ratings might not lead towards sustainability improvement. The authors advise companies to maintain a close and sound ongoing relationship with ESG ratings providers, by establishing "open and transparent disclosure standards and ensure that the data is publicly accessible" (Berg, Koelbel, & Rigobon, 2019). If companies foster standardized sustainability reports and better communication, then third party ESG ratings providers will receive clearer signals towards their ESG performances.

On the investors' side, the SustainAbility report finds that, to some extent, they are reticent towards ESG ratings. Indeed, the investment community denounces a lack of "quality, effectiveness and impact of corporate ESG ratings" (Wong, Brackley, & Petroy, 2019). Several publications offer solutions for investors in their interpretation of ESG ratings.

In the first place, investors should keep in mind that this tool is an opinion and does not necessarily represent the reality. It should be treated as a starting point and should not be taken for granted (Bos, 2020). In order to complement ratings, responsible investors should combine those corporate scores with deeper in-house analysis towards ESG integration (Schoenmaker & Schramade, 2018). The SASB framework may also help them in understanding which material sustainability concerns affect each industry. Furthermore, investors should ask for more transparency from rating providers in their assessment of material ESG performances. As mentioned before, Khan, Serafeim and Yoon (2016) suggested that firms which deliver good sustainability credentials in terms of material issues outperform firms which deliver good sustainability credentials in terms of immaterial issues. Artificial Intelligence helps gaining up-to-date ESG data, such as the tools offered by TruValue Labs (Serafeim, 2018).

When it comes to measurement divergences, Berg, Koelbel & Rigobon (2019) advise investors to develop their own weighting methodologies to decrease discrepancies between ESG ratings providers. Additional research on the companies' sustainability status quo is also encouraged. As far as the improvement of convergence in the future is concerned, Chatterji, Durand, Levine and Touboul (2016) suggest that the increasing consolidations in the ESG ratings and research market might enhance the validity of the rating, but the subject has not been thoroughly studied yet.

In conclusion, this chapter allowed us to realize how divergent and subjective ESG ratings may result. Even though many pitfalls exist, the solutions provided by some authors towards integrating ESG ratings might help in the process of interpreting this sustainable finance tool. Enhanced and timely data, more standardized disclosures from companies and transparency are the key elements which will improve the overall quality and reliance on ESG ratings. When a cautious approach is used, ESG ratings do provide valuable insight.

# Part 3 Methodology

## Chapter 5 Choice of research strategy

After a systematic review of the relevant literature, a complementary analysis is performed to understand the investing community perspective around the sustainability ratings market. In this study, the stated objective is to present a review of sustainability ratings offered by third parties. This second practical step adds on to the theoretical chapters and it will be shaped through interviews to institutional investors in sustainable finance.

The analysis is qualitative, following the subjective nature of "assessing" ESG ratings. The goal is to gather opinions and criticism, while discussing how relevant this tool is for investors. The qualitative research strategy aims at testing concepts specified before the data is collected, in the academic review. We enhance the credibility of the research, by coupling the data collected during the interviews with other sources, in a process called 'triangulation' (Bryman, 2012). This way, desk research is performed through the collection of secondary data on the ESG investment approach of the same institutional investors which is publicly available.

This analysis will help validate or invalidate the findings within the academic literature and it will also contribute to further answer the research question, which is: "*What is the value of ESG ratings for responsible investors in allocating capital towards sustainable companies?"*

### Section 5.1. Sample construction and data description

In order to help answer the research question, both primary and secondary data are manipulated. The empirical study is devoted to the opinions and criticism of investors. It reflects upon the causes of ESG ratings impressive development in order to fill in an existing gap.

#### 5.1.1. Primary data collection approach

The primary qualitative data consists in in-depth interviews, performed in a semi-structured way. This data collection technique allows to both leave the discussion open for further comments and to foster an organized conversation going through key topics. The core advantage of conducting semi-structured interviews is the flexibility it offers. Indeed, it gives a broad frame for the interviewee to interpret the question and to answer accordingly. It also enables to pick up on some important remarks that were not basically in the interview guide (Bryman, 2012). This justifies the choice of the semi-structured instead of structured interviews, as one may adapt quickly to an unforeseen situation.

*Selection of sampling*

We use a purposive sampling to select the stakeholders, and snowball sampling as a second means to gather participants, asking contact details from previous interviewees (Bryman, 2012). The sample has been deliberately chosen to perform the analysis, in order to optimize the reliability and validity of the data. This decision is guided by the eagerness to collect meaningful data to contribute to the final discussion. The sample has been constructed as follows:

The qualitative interviews were conducted with institutional investors. One of the reasons being that it is easier to contact institutions than retail investors. Furthermore, institutional investors are larger in terms of managed assets and funds as they represent a broader category of investors. They have thus a higher impact when it comes to transiting their funds to sustainable projects. They also have more resources to devote to ESG ratings and research.

Our data collection was driven by the signature by institutional investors of the UN Principles for Responsible Investments (PRI). This aims at targeting specifically responsible investments operators. We focused on institutional investors which have well established investments throughout Europe. Interviews were engaged exclusively with either people in charge of an ESG team or SRI department, or experienced employees truly familiar with ESG ratings.

The interviewees were contacted through our personal network, via email or the social media LinkedIn. The demand sent provided the recipient with a short description of the research question, highlighting that their experience might be a true value added for this study. Due to the COVID-19 outbreak, the means of communication were adapted and interviews were carried out by video conferencing (with Microsoft Teams, Skype and Zoom) and by phone.

*Interview guide*

In elaborating the interview guide, we kept in mind the research question and its various sub topics. Going through our own literature review, key themes referring to the common thread of this work were highlighted. While reading, we noted a list of points that were relevant to answer the question. They were then revised and assembled in an interview guide, subject to improvements throughout the whole process of interviews, on the basis of further insight from our interviewees. The main areas were ordered as follows:

- Warm-up questions
- ESG integration methodology
- Integration of ESG ratings within investment approach
- Collaboration with specialized agencies, data providers, rating agencies
- Opinion and criticism about ESG ratings
- Future of ESG ratings

The final interview guide may be found in the Appendices (*cfr.* Appendix V. ). All participants accepted to be recorded during the interviews.

### 5.1.2. Secondary data collection approach

The secondary data includes a complementary data base which is mainly composed of publicly available documents from investing companies, which, in the recent years, have increasingly developed reports on the strategic integration of ESG in their investment decisions.

The UN PRI database is analysed, as providing transparency reports on most of the signatories. The search results show the signatories in the data set, where the latest transparency report may potentially be found, despite not always being available (PRI, 2020a). Those self-established reports are the crux of investment management's memberships, because they describe long-term strategies related to the six PRI principles (*cfr*. Appendix III. ).

## Section 5.2. Strategies for qualitative data analysis

The performed analysis is the core part of this master thesis, as it empirically addresses the research question. The description of the methodology applied to analyse the collected data constitutes a crucial step to ensure consistent and reliable conclusions. The qualitative research strategy aims at testing concepts specified in the theoretical framework of this paper. Triangulation with secondary data will support the outputs from interviews.

The first stage of the research aimed at preparing the interviews, by means of analysis of the UN PRI database. This way, we got acquainted with the responsible investment methodologies selected by the institutional investors to be interviewed. It helped us go straight to the point without spending too much time on publicly available information.

The following step consisted in coding, meaning allocating to some key themes the data retrieved from interviews (Bryman, 2012). This process was ongoing, and started as soon as the discussion with the investment professional was over. By so doing we gained a profound understanding of the opinions and concerns of each interviewee. While writing down the transcripts of the interviews, further notes were taken to complement the topics addressed.

Once all the interviews were conducted, we took a deeper look at the previously chosen codes and put them side by side with the themes most frequently covered in the literature review. At that point we were left out with five main themes:

- Integration of ESG ratings within the responsible investment approach
- Criteria for selecting ESG ratings providers
- Limitations and precautions taken to counter drawbacks
- Evolution and future of the sustainability ratings market

These topics are subdivided in several subcategories to allow a comparison between institutional investors. To summarize the assessment of ESG ratings, recapitulative tables are provided in Appendix VI. to Appendix X. Both primary and secondary data were exploited to complete the tables. This working method fosters an easy comparison between participants and is the basis for the analysis.

# Part 4 Analysis and Discussion

## Chapter 6 Interviewees sample

The primary data results from nine in-depth interviews, collected from a panel of institutional investors across Europe, notably from Norway, the Netherlands, Belgium, Luxembourg and France. Out of twenty-two direct requests sent, the response rate was of 50%. Indeed, due to the snowball sampling, two interviews were deemed not relevant afterwards for the practical research, and they are thus filtered out of the analysis. The discussions were conducted in French with four people, and in English with the other five. One should notice that throughout the interviews, mainly corporate ESG ratings were touched upon, leaving little room for country ESG ratings (which is not the focus of this paper).

The quality of the conducted interviews highly depends on the position of the interviewees and their expertise on ESG ratings. The interviews aim at covering a broad spectrum of European institutional investors in order to build a robust analysis. Among others, we gather interviews from three Heads of Responsible Investments, working for the largest asset managers in Europe. Among them, we discussed with[11]:

- Amundi Asset Management (Amundi), interviewing Frédéric Samama, Head of Responsible Investments;
- AXA Investment Managers (AXA), interviewing Matt Christensen, Global Head of Impact Strategy and Responsible Investments;
- BNP Paribas Fortis (BNPPF) in Belgium, interviewing Guy Janssens, Head of Sustainable and Responsible Investments.

Amundi is Europe’s largest asset manager in terms of assets managed (Eurosif, 2018) and BNP Paribas Fortis is the largest player in Belgium.

[11] For the sake of clarity, acronym or simpler formats (shown in brackets) will be used throughout the analysis for the interviewed investors.

The sample also includes recognized leaders in sustainable investment in Europe, such as:

- Degroof Petercam Asset Management (DPAM), interviewing Ophélie Mortier, Head of ESG Research and Responsible Investment strategist;
- Folketrygfondet, Manager of the Norwegian Government Pension Fund (only for Nordic investments), interviewing Annie Bersagel, ESG Portfolio Manager;
- NN Investment partners (NNIP), interviewing Daniel Peter, Responsible Investment Specialist;
- Triodos Investment Management (Triodos), interviewing Roeland Tso, Responsible of Impact Reporting for stock listed securities.

Less advanced profiles, but nonetheless pertinent for the case were:

- Gjensidigestiftelsen foundation, interviewing Isabelle Juillard Thompsen, Portfolio Manager;
- Orcadia Asset Management (Orcadia), interviewing Etienne de Callataÿ, Chairman and Founder.

The table below highlights the studied investors' profile.

| *Institutions* | *Investor class* | *AuM[12] (in € or NOK)[13]* | | *Country* |
|---|---|---|---|---|
| | | *Total* | *ESG / RI* | |
| *Amundi* | Asset manager | €1.527tn | > €320bn | France |
| *AXA* | Investment manager | €801bn | €508bn | France |
| *BNPPF* | Asset manager | €1.123bn | €47bn | Belgium |
| *DPAM* | Asset manager | €54.7bn | €4bn | Belgium |
| *Folketrygfondet* | Manager of the Government Pension Fund Norway | NOK254.8bn[14] | | Norway |

12 Asset under management.
13 Most recent public numbers retrieved online (as of 21st of May 2020).
14 As market value.

| | | | | |
|---|---|---|---|---|
| *Gjensidigestiftelsen* | Asset owner<br>Financial foundation | Not available | | Norway |
| *NNIP* | Investment Manager | Total: €276bn | Not available | Netherlands |
| *Orcadia* | Wealth Manager | Not available | | Belgium |
| *Triodos* | Investment Manager | €4.2bn | | Netherlands |

***Table 3*** *Interviewed institutional investors (sources see Appendix VI.).*

Building on this table, in Appendix VI. we provide detailed information about the participants together with a summary of the type of institutions, the country of origin, the amount of assets under management (if publicly available), the function of the interviewees and the status of signature of the UN PRI. The transcripts of interviews are only available to the examiners (*cfr*. Appendix XI. ).

# Chapter 7 Results

## Section 7.1. Integration of ESG ratings within the responsible investment approach

In this section, the underlying reasons for working with ESG ratings are explained. We also describe how ESG ratings are integrated within the investment approach of the interviewed institutional investors. A summary table can be found in Appendix VII.

### 7.1.1. Motivations for using ESG ratings

In most cases, institutional investors use inputs from third parties regarding sustainability assessment of companies, funds or countries. And that happens for a variety of reasons.

From smaller to larger investors, there is an apparent lack of expertise and means to develop a sustainable assessment internally. It would indeed require many ESG analysts to go through all the sustainability reports, controversies, news, etc., and to cover all asset classes with a comprehensive ESG research. To that end, professional investors subscribe to ESG rating agencies. DPAM for instance mentioned that they do not have the internal capabilities to perform the research in-house. ESG ratings are thus necessary as a basis for an ESG approach.

Another reason is that many stakeholders are investing in funds, which in turn are based on a sustainability index. As they are willing to understand the ESG funds' composition, professional investors need to subscribe to ESG rating agencies. Indeed, in order to ensure that indices are consistent with their preferences, institutional investors have to understand the rationale behind those indices. For instance, as Orcadia mainly invests with the help of sustainability indices through negative and best-in-class screening, for them it is paramount to understand their composition. Gjensidigestiftelsen, instead, analyses in-depth the index funds in which they could possibly invest by verifying the ESG performances of the stocks composing the index, and thus, the ESG ratings. For larger actors, such as BNPPF, they are investing in, making and creating products out of sustainability indices. This means that ESG ratings are absolutely fundamental, just as it is fundamental to understand properly their composition.

In the same vein, AXA, BNPPF and Amundi do not only feed the sustainability indices they create with ESG data, but they also use it to develop an in-house score. Firms gather the sustainable scores from numerous providers, and incorporate them directly in their own measurement. Concretely, they use this tool as the very first step of their own ESG assessment framework, as NNIP does. They dismantle ESG ratings, and only use the raw data to fuel their in-house evaluation. Sustainability ratings also serve as a double check for investors, to complement the assessment they are making. It may as well generate alpha, according to BNPPF and Gjensidigestiftelsen.

However, Triodos's responsible investment strategy works otherwise. One should notice that they "only invest in companies that contribute to a sustainable society" (PRI, 2020a). The total AuM reaches an amount of €4.9 billion, the totality aiming at benefiting people and the environment. ESG data and ratings are incorporated within internal processes, but the main reason for using ESG ratings is the increasing demand from clients. Indeed, asset owners are asking them to rely to some extent on sustainability data, because this "officially" ensures that Triodos funds and portfolios are genuinely sustainable. Triodos is not the only investor to be motivated by this reason. BNPPF is as well encouraged by clients to use this tool. DPAM sees it as a necessity in order to be granted Belgian labels, which is what asset owners demand. Indeed, certain labels require to rely on ESG ratings.

Folketrygfondet, manager of the Government Pension Fund Norway, is an exception since it cancelled its subscription to a sustainable rating agency last year. Investee companies are covered directly by the portfolio managers, which means that ESG ratings are not adding any value to the analysis.

### 7.1.2. Integration of ESG ratings within the investment approach

Regarding the incorporation of ESG ratings within the sustainable investment approach of the firms, key trends can be identified thanks to the interviews. In all cases, the integration of the scores is directly embedded in the evaluation process. As this paper focuses on the value of ESG ratings for assessing *sustainability* performances of companies, we did not cover to what extent investors integrate this tool to assess *financial* performances (i.e. valuation).

A first emerging integration pattern is the need for ESG ratings for screening purposes. For negative screening (used by all stakeholders, except Folketrygfondet), they lead to leave out companies which perform badly on some sustainability criteria. In best-in-class screening (DPAM, Orcadia, BNPPF, Amundi), they are integrated to spot the top performers within an industry. Alternatively, they may be embedded in positive screening (Triodos, Gjensidigestiftelsen), selecting the companies which are compliant with key sustainability topics (e.g. SDGs). The case of Triodos is worth delving into, in a sense that ESG ratings are used throughout the whole investment approach, consisting of three stages. The first one is positive screening, internally called "First Impression Scan" and aiming at looking for companies driving positive externalities. In accordance with seven transition themes (e.g. renewable resources), external ESG ratings and research help to understand the revenue breakdown towards a specific theme. The second stage is the "Minimum Standard Scan", an exclusionary screening, which helps find out whether a company breaches a particular standard. In this case, ESG ratings are used to filter out companies which could be involved in controversial subjects (e.g. nuclear power). In the last step in the process, analysts dig deeper into each of the criteria, the 'E', the 'S' and the 'G' of the rating. This is recognized as the "Fully Integrated Dashboard". This example has shown that the use of ESG ratings is not limited to one moment in time, since in some cases this tool is truly embedded throughout the whole investment approach.

There is also a need for raw ESG data, fuelled within the ESG research of third parties. Some institutional investors screen companies thanks to ESG ratings as they receive them (e.g. Amundi), while some others proceed to a deeper analysis, considering exclusively the ESG data underlying the aggregated final scores. Three stakeholders –AXA, BNPPF and NNIP– further delve into the data that has fed the sustainability score. With this raw data coming from data vendors, they develop their internal ratings and frameworks. On the one hand, sustainability data is truly necessary for NNIP, as they start their investment-decision process by feeding raw ESG data "into [their] proprietary ESG assessment framework capturing a company's relative ESG performance" (PRI, 2020a). BNPPF, on the other hand, creates its own internal scores. ESG raw data also helps AXA by finding new sources of investments and it guides "investors in their company to make better informed decisions" (Interview with AXA).

For Gjensidigestiftelsen, sustainability ratings are decomposed in pillars, and serve as baseline for their investment decisions. Triodos analysts go truly in-depth into the ESG research, by exploring the corporate revenue breakdowns, exposure to defined themes, controversies, etc. They integrate the raw data directly within their investment approach.

A case stands out from the analysis: Orcadia invests by means of indices and trackers. Investing with responsible values, they rely entirely on ESG ratings and indices and they do not perform further internal analysis. This is explained by their relatively small size compared to other institutional investors.

This section has highlighted several trends. For players which are large enough to have analysts performing further ESG research, ESG ratings are used as a very first screening step, or as input for in-house ratings. Sustainability scores are then double checked internally and coupled with a complementary discussion with companies. For smaller players, which do not have the means to hire sustainability specialists, ESG ratings are used as they receive them.

A very relevant result is the absence of clear trends related to the amount of companies' AuM. For instance, AXA and Amundi, the two largest asset managers, are using ESG ratings differently. While the first is only working with raw ESG data, the latter is fueling its in-house score with aggregated ESG ratings. In light of these differences, we were unable to categorize investors by the amount of assets managed with an ESG filter. This puts forward that it is not the size of the investing firms that determines an ESG behavior, but rather other – sometimes unique – elements.

A final remark on the integration of ESG ratings was made by the responsible investment specialist at NNIP. The interviewee mentioned that:

> "*When it comes to impact investing, I would say that a lot of our peers are already too sophisticated for what data providers can deliver.*"

In case of impact investing, these sustainability scores are not sufficient, but for basic ESG integration strategies they have proven to be convenient.

## Section 7.2. Criteria for selecting ESG ratings providers

Following the methods for integrating ESG ratings, it is interesting to understand the reasons behind subscribing to specific third parties. From one institutional investor to another, there are heterogenous criteria to select one or several ESG ratings providers. The results are shown in a summary table in Appendix VIII.

Concerning the criteria for choosing the ESG ratings providers, several common trends have emerged from the analysis. In order to depict the motivations to work with specific data providers, this section is divided into subsections, each dedicated to different categories of rating provider . One should notice that the CRAs are further mentioned in the following Section 7.4., as this market is expanding, but at the moment it does not provide tools actually used by institutional investors.

### 7.2.1. Sustainable rating agencies

Before we investigate the criteria for choosing the SRAs, a striking observation is that mostly all institutional investors are either relying on MSCI or Sustainalytics. In fact, MSCI is the most frequently mentioned in the interviews. For instance, even though Folketrygfondet decided to terminate its contract with the above-mentioned provider, they had been working together until a year before. Triodos seems like an outlier, by choosing to collaborate with ISS ESG and the suite of tools it provides, but this will be explained later on.

A general motivation to choose ESG ratings agencies relates to the coverage. Institutional investors are willing to subscribe to an SRA which is able to provide assessments for the largest set of companies possible worldwide. It is partly for that reason that MSCI and Sustainalytics are preferred and almost systematically used, as clients can count on only one – or a few – player(s), thus saving time and money.

Reputation and recognition also play an important role in selecting SRAs. In terms of frequency of use by our panel of institutional investors, the two biggest players are MSCI and Sustainalytics. They both have succeeded to impose their names as global players in the sustainability ratings market. In the same vein, larger institutional investors, such as Amundi and BNPPF, mentioned that they took the "*most important data providers*" (Interview with BNPPF). A different example concerns NNIP: as Dutch investor, they started to work with Sustainalytics, whose headquarters were in Amsterdam and had the best reputation when they chose them.

An important observation concerning the selection of ESG ratings vendors is the following: the largest the amount of AuM (Amundi, AXA, BNPPF, DPAM, NNIP), the highest the number of subscriptions to niche or specialized data vendors. AXA mentioned for instance that MSCI is better recognized for North America, while Vigeo Eiris is better on the French market. This is generally justified as to have access to a set of comprehensive ESG information, each provider having its own expertise.

Flowing from this analysis, we note that subscriptions depend to a large extent on the expertise and adds-on themes offered by third parties. As a matter of fact , MSCI is deemed to have more analysts and is more focused on financial risks, while Trucost is often acknowledged for its environmental expertise and Sustainalytics for its personalization and its quantitative analysis. Other players stand out as niche providers, filling a gap in the ESG ratings market. Even though less widely recognized, some firms offer specific expertise on SDGs (e.g. Green 17), on controversial issues (e.g. Factiva, RepRisk), or on controversial production of weapons (e.g. ISS Ethix). An important point to be made is that an increasing number of investors are using unconventional third parties, such as TruValue Labs, which offers Big Data solutions (mentioned in Section 3.6). This tool does not provide ESG ratings in itself, but may send signals on controversies. TruValue Labs was quoted by several interviewees, irrespective of the size of the firm (Triodos, Amundi, NNIP). AXA is currently in talks with them as well.

As noted before, the larger the firm, the larger the means it can deploy to subscribe to various rating agencies. We discern a vast difference compared to small and medium players (Gjensidigestiftelsen, Orcadia Asset Management, Triodos), where it is only financially possible to select one rating agency (though Triodos is using the services of TruValue Labs).

A last criteria that should be touched upon is the choice to work with an ESG rating agency to match one's own specific investment approach. We can think of Triodos, exclusively specialized on impact investing. After terminating their previous subscription to Sustainalytics, they were truly willing to collaborate with an external data provider in line with their own needs:

"*As we have truly switched to impact investing, […] we made our choice indeed for ISS ESG.*"

– *Interview with Triodos.*

### 7.2.2. Sustainable indices

Sustainable indices were not covered as thoroughly in the interviews, as only four respondents mentioned they use them as ESG ratings. Some of the largest, such as Amundi, BNPPF and DPAM, are using the sustainability indices as references. They create their own products based on a family of indices. Just as observed for SRAs, MSCI is once again mentioned at the top as ESG indices providers.

Orcadia replicates its investment mainly from MSCI ESG and MSCI SRI, especially because they are renowned for indices. Not only for sustainable indices, as MSCI has a record for standing up in the benchmark markets.

Triodos behaves differently and tracks approximately two hundred companies in its investment universe by using their own reference index.

### 7.2.3. Financial information platforms

The last category of ESG rating providers is represented by financial information platforms. We may start with Bloomberg, offering sustainability services to all institutional investors interviewed. Indeed, it displays several ESG analysis thanks to the <BI ESG> function (*cfr.* Appendix II. ). In most cases the Bloomberg Terminal is useful to "double check" and allows to follow the material news. Despite not having subscribed to any rating agency, Folketrygfondet regularly relies upon the timely and reliable data it may find there.

Gjensidigestiftelsen, another Norwegian institutional investors, does subscribe to MSCI for ESG ratings. In this case, its use of the Bloomberg Terminal is less regular, and is mainly to verify industries' ESG performances. Orcadia strengthens its sustainable investment decisions by also checking the aggregated scores by RobecoSAM and Sustainalytics on the Bloomberg Terminal, which may in turn impact their decision to invest or not in some values. Bloomberg also serves as a basis for Amundi's passive funds, in order for instance to create ETFs and index funds (PRI, 2020a).

Another financial information platform discussed during the interview was Refinitiv. This platform is valuable for two institutional investors, i.e. BNPPF and NNIP. The latter deems that Refinitiv displays good information in terms of environmental and governance criteria, based on annual reports. BNPPF makes use of Refinitiv if there is demand from clients.

To sum up this section, the criteria chosen depend on several factors, and surprisingly, there is no clear pattern standing out from the analysis when it comes to ESG ratings integration. This means that the reasons to work with some data vendors are neither manifest nor easily interpreted. The subscription to one or more ESG ratings provider(s) is more a case-by-case assessment, and not a one size fits all. However, one may notice that MSCI and Sustainalytics clearly stand out as a reference for SRAs and sustainability indices.

## Section 7.3. Limitations and precautions taken to counter drawbacks

The third core part of the interviews concerned the challenges implied by ESG ratings utilization. Beforehand, we identified the needs for this tool. It now appears crucial to identify the main drawbacks encountered by the responsible investment community interviewed (*cfr*. results Appendix IX. ). The first part of this section will uncover the challenges faced by institutional investors in integrating this tool, and the second part will elaborate on the precautions to minimize the negative consequences of using ESG ratings.

### 7.3.1. Drawbacks of ESG ratings

The first point of criticism concerns the methodology of the rating agencies. Often, the interviewed investors identified a lack of transparency. It appears very complex to delve into the "*black box*" (Interview with BNPPF) of third parties' methods, and to genuinely understand what it contains, which criteria or indicators are assessed, etc. All respondents said they hoped that dimension would be improved.

And yet, understanding in depth how the ratings are constructed is key to choose the rating agency they would collaborate with. Another point of criticism relates to the materiality of factors, meaning that sometimes interviewees find it difficult to match their own preferences with the aggregated ESG score. DPAM mentions that they cannot edit the weightings themselves, according to the relative importance they attribute to some key concerns. MSCI dictates what is important and what is not. Not only the rating agencies' views appear biased and subjective, but it seems also that they sometimes do miss some real issues in some industries. Three interviewees (DPAM, Folketrygfondet and Gjensidigestiftelsen) talked about the fisheries and food industries as being misunderstood by ESG ratings vendors. It is in this context, for instance, that Folketrygfondet decided to discontinue its subscription to MSCI:

*"We are a 100 percent actively managed fund. […]it was quite rare that we actually came across something in the MSCI analysis that we weren't aware of before. And more commonly we came across elements just suggesting that maybe they didn't understand the company that well."*

*– Interview with Folketrygfondet.*

Expertise seems to be lacking in some industries compared to others. Another point of criticism around the integration of materiality is put forward by both Amundi and Orcadia, despite their very different sizes. They believe ESG ratings should integrate further criteria, such as the lobbying rate of the companies, or the tax optimization rate (tax evasion is particularly relevant in times of Covid-19, according to the chairman of Orcadia).

Data provenance, in turn, was highly discussed by Triodos, AXA and NNIP, pointing out a time lag between the ESG ratings, and the "current" ESG level of a company. This was justified by the provenance of the data, because ESG rating agencies are often relying on annual reports from the year before.

Triodos and AXA both think that ESG ratings are backward looking, because rating agencies tend to assess the current state of the company and are not considering future-oriented information. Concerning data provenance, the questionnaire-driven analysis was challenged, notably by DPAM, because it supposedly does not give a proper vision of the company and implies a conflict of interest. The interview we had with Amundi showed an additional drawback: raw ESG data and ESG ratings are provided by the same players, whereas it should be provided by companies, like the financial data.

As far as the firm size bias is concerned, DPAM and NNIP were highly critical. Indeed, they have noticed that the more a company publishes, the better ESG scores they will get. In the case of DPAM, this is why they mainly use ESG ratings to compare large companies within a similar universe. The specialist interviewed at NNIP highlighted that bigger companies, such as Shell, have way higher means to develop a comprehensive sustainability report. The consequence might be that rating agencies are wrongly influenced by the costly reports. The interviewee added that the same goes for regions: some European countries, being forced by law to a heavier reporting burden, have better scores than Asian countries.

Interviewees confirmed, unanimously, the divergences in the ESG ratings. AXA referred to them as a major critical point, as making this tool very confusing for people. Subsequently, they were asked to explain the reasons behind those divergences. They specifically mentioned the different methodologies (e.g. different indicators for the same criteria), the lack of standardization and the peers relativity within the same industry.

Another limitation was discussed by NNIP, Gjensidigestiftelsen and BNPPF: the cost of services provided by external parties. They are particularly expensive for smaller players, making it difficult for them to gain qualitative and reliable ESG insights. Two stakeholders (Triodos and Folketrygfondet) equally pointed out that a few analysts cover too many companies. It is thus difficult to assess a company on sustainability performances in full. According to Folketrygfondet, this explains the low expertise that ESG analysts might have on the Nordic countries, not forgetting that, besides that, headquarters of rating agencies are located mainly in central Europe. DPAM has also expressed criticism about its ESG rating providers: sometimes, it seems that the ESG ratings do not match the qualitative comments made on the side of ESG reports, as if they were talking about another company.

All in all, criticism mainly focuses not on ESG ratings as such, but rather on their integration in investment decisions among their peers. More than criticizing for the sake of it, interviewees voice their fear that some so-called "responsible" investors, are using those ratings as they receive them, without stepping back and thinking whether they fit their own needs. According to some interviewees, it is crucial to understand the underlying consistencies of those ESG ratings in order to avoid the risk of producing counter-intuitive results. This fear was addressed by DPAM and NNIP mainly. Triodos adds on to this by stating:

*"The point remains that you cannot simply buy ESG data and then say that you're sustainable. You really have to understand what's behind it".*

#### 7.3.2. Precautions taken in using ESG ratings

A key finding in the previous analysis, is that all the interviewed investors were quite critical about ESG ratings. Acknowledging this fact, some have developed ways to counter the drawbacks of their integration within their investment decisions.

One of the main reasons to use several providers is to enhance the reliability and the validity of ESG ratings, avoiding bias or misinformation which could result from subscribing only to one third party.

Another way to override the limits of this tool is to develop an internal ESG assessment. At first glance, this is feasible only for very large asset managers with the means to develop in-house scorecards. However, a smaller player like Triodos has chosen to define impact investing as a compulsory criterion. Internal ESG research also consists in active ownership (for equities, and not for lenders), implying that some institutional investors talk directly with the investee companies to question their ESG ratings. This is true only for those investors who have an active ownership ESG integration approach. Some adjustments are also made depending on knowledge and expertise of a specific industry (e.g. Gjensidigestiftelsen).

Possibly, a last precaution is to subscribe to other types of providers, displaying ESG raw data and big data. Triodos, NNIP and Amundi, for instance, make use of TruValue Labs and its big data services, which provides signals on positive and negative controversies that may affect a company or an industry. As for AXA, a collaboration with TruValue Labs is currently under consideration and it will probably turn out to be the next wave of sources for ESG information.

Orcadia is being an exception in that matter, because it believes that MSCI has better means to assess a company on ESG performances. They are aware that some drawbacks exist, but they reckon that they are not better than MSCI at valuing a company on sustainability issues.

## Section 7.4. Evolution and future of the sustainability ratings market

Within this section, the analysis is attempting to grasp other issues at stake in the sustainable ratings market. It also outlines the opinion of institutional investors about the future awaiting this market.

### 7.4.1. Consolidation within the sustainability ratings market

The interviewees had the chance to discuss their opinions and reservations on the numerous consolidations that are happening in this market, and how they could affect, – positively or negatively – their investment practices.

Many positive aspects of a consolidating ESG ratings market were already mentioned, most commonly the enhancement of capabilities and expertise. Rating agencies are also increasingly stimulated to offer a broader set of services, allowing customers to subscribe only to a few providers, for several criteria (the ‘E’, the ‘S’ and the ‘G’ are most likely all covered by only one third party, whereas in the past, one should have subscribed to many different agencies). With more means, consolidated groups are also able to offer better IT capabilities, better organization, and more professionalism. For instance, DPAM dropped their collaboration with Vigeo (before merging with Eiris), because they had many IT issues. To cope with discrepancies in ratings, AXA believes that the mergers and acquisitions might lead to less variance.

Another optimistic note covered in the discussions was the harmonization of the market, bringing more transparency with it. Those consolidations might also help ESG ratings, and sustainable investment as a whole becoming mainstream.

Some interviewees show skepticism about consolidations. Indeed, some fear that the decrease in competition might lead to an oligopoly or duopoly, where only a few players dictate which companies are doing good, while the rest is left aside (Orcadia, Folketrygfondet, DPAM, BNPPF, Amundi). The interviewee from Amundi, for instance, has concerns about mergers and acquisitions on the CRA model, which allows a few American companies to decide which firm is the leader. For AXA, all rating agencies being acquired by US firms would be “*one of the biggest issue that you can have*” (quote from interview with AXA). Indeed, the ESG momentum initiated by Europe should be owned by Europe.

It seems also that consolidations tend to lower the critical spirit of rating agencies, as they are losing independence. With fewer competitors, there are less reasons to innovate. Furthermore it will also lead to higher pricing power (NNIP).

#### 7.4.2. Credit rating agencies’ role in the ESG ratings market

The role of CRAs in the ESG ratings market does not seem to be a hot topic among the institutional investors. From some interviewees, we perceived a certain degree of tension related to the CRAs, though without an explicit link to ESG ratings. Nonetheless, it was mentioned that credit ratings are oftentimes suffering from conflict of interests contrary to ESG ratings, as it is most commonly investors – and not issuers – that are paying for the assessment. Some also worry that someday the American oligopoly could once again prevail (S&P, Fitch and Moody's).

A Belgian investor noted that CRAs might have an increasingly important role to play in the ESG ratings market, especially because their maturity makes them more professional. They are subject to regulations forcing them to be more transparent in terms of methodology, which is not the case for ESG ratings agencies yet. Another interviewee thinks that traditional agencies will gain market shares, as it is crucial to integrate ESG risks into credit risks.

### 7.4.3. Room for improvement

As a side-effect of criticism, many interviewees have offered suggestions for possible improvements of this tool and of the ESG ratings market as a whole.

Speaking of the limitations arising from the lack of transparency, more than half of respondents are awaiting for more standardization and regulations on the ESG ratings market. In Europe in particular, they believe that the European Commission might play a regulatory role.

Others are more skeptical, however. Amundi's representative thinks that standardization of this market is not a core objective of the EC, for example. Triodos also shows some criticism, believing that the threshold to obtain EU labels is too low. But interviewees expect results from other directives, such as the one on corporate disclosure from European Supervisory Authorities. This could have impacts on the outlook of ESG ratings, because providing raw ESG data would become the role of the firms, and not of the rating agencies themselves, thus bringing more convergence in the market. This opinion is shared by AXA, as the quality of ESG ratings will probably get better over time, partly due to the increasing amount of mandatory corporate disclosure. The EC will push firms to deliver non-financial reports.

Some others are betting on improvements that could enhance this market. One of them would be better coverage, especially in the Nordics (Folketrygfondet, Gjensidigestiftelsen) and for smaller companies with less means for sustainability reporting. A decrease in prices would as well make it mainstream for all classes of investors. In the same vein, the respondent from BNPPF advocates for better access to ESG ratings. This would give a sense of corporate sustainability performances to all stakeholders. Amundi and Orcadia ask to integrate more evolutive components in the ratings, such as citizenship and lobbying criteria. To complete the picture, three investors mentioned that ESG ratings should be more timely, with the help of Artificial Intelligence for instance.

#### 7.4.4. Future outlook and challenges to be addressed

Regarding perspectives on the future of ESG ratings, interviewees are not unanimous. Some recommend to take third party scores with caution, as ESG ratings and research have the power to dictate what is sustainable, channeling investments towards a certain set of companies. Another challenge to be addressed in the future is the easiness of use of ESG ratings.

Finishing on a more positive note, many believe that this tool will become mainstream in the years to come. For instance, Amundi is targeting 100% of its investments to be filtered with ESG criteria by 2021, and BNPPF is announcing the same targets, integrating ESG in all their investments-decision making. In order to do so, institutional investors will need the help of ESG ratings to screen tens of thousands of companies worldwide. The Head of Responsible Investment at BNPPF in Belgium, even talked about a mandatory ESG-rating next to a risk-rating. And he is not the only one to predict a great future for ESG ratings.

# Chapter 8 Discussion

This chapter has the objective to sketch an answer to the research question by discussing both the academic review and the main results stemming from the nine interviews. It will draw conclusions on the way ESG ratings bring value to the investment industry to contribute to a sustainable society, unveiling its use by European institutional investors. The significance of our findings is subsequently demonstrated by further digging into the contribution to management of the present research.

## Section 8.1. Results discussion

ESG ratings serve as a driver to guide capital towards sustainable investments. For the smallest and the largest investors alike, this tool has become much-needed over the years. It provides a quick scan of E, S and G performances on thousands of companies. However, pressing questions from regulators, academics, investors and companies have casted some doubts on the validity and relevance of ESG ratings.

### 8.1.1. State of play of ESG ratings

Echoing the research from the European Commission on sustainability ratings and research, we investigated the state of play of the ESG ratings market in Europe (*cfr*. Appendix IV. ) and the growing importance of this tool for different stakeholders. The specific focus on institutional investors enabled to understand how valuable this tool is in practice and how it is integrated into the socially responsible investment strategy of firms.

Due to limited resources and expertise, institutional investors find it necessary to collaborate with third parties in order to get a sustainability assessment of companies. We find that ESG ratings are genuinely relevant for the respondents, by being integrated not only for screening reasons (i.e. negative, positive and best-in-class), but also to meet a growing demand from clients. This tool gives a global momentum to transit towards a sustainable economy, as it helps shifting investments to companies with better CSR credentials.

Exploring the main players in this ESG ratings market, the analysis of the interviews helped us to outline a rating providers' map that differs from the academic review. It emerges that investors have a high preference for MSCI and Sustainalytics because they offer a comprehensive set of data, which is renowned and covers a broad range of companies worldwide. According to our respondents, RobecoSAM, CDP and ISS ESG are not the most valuable SRAs. However, in the academic review, those were extensively mentioned as leaders in the industry. That was the conclusion of the study Rate the Raters from SustainAbility (Wong, Brackley, & Petroy, 2019), of the scientific article about the sources of divergence of ESG ratings (Berg, Koelbel, & Rigobon, 2019) and of a comparative study targeting various ESG ratings providers (Dorfleitner, Halbritter, & Nguyen, 2015). One should note that ISS ESG has however gained ground, notably on one player focusing only on impact investments and on two French asset managers.

Despite offering various sets of ESG data, Bloomberg, is not considered as leader in sustainability assessment. It seems that there is a long way to go for investors before they rely on the Bloomberg Terminal for their decisions in terms of ESG investing. Refinitiv is only of little use for investors, their ESG rating branch not having been able to seduce many yet. It could also be argued that sustainability indices are of a great help particularly for investors that are passively investing. Concerning traditional rating agencies, institutional investors do not yet see a role for them to play in responsible investment, although it is increasingly discussed (Cash, 2018). Markets for ESG ratings seem to be dominated by specialized rating agencies (i.e. SRAs) and by sustainability indices, though to a lower extent.

An additional perspective covered in the analysis is the set of criteria to choose rating agencies. Indeed, the subject of the selection process has not been brought up in the literature review. Thanks to the analysis of the interviews we identified the five main criteria applied in the selection of a rating agency: the coverage it offers, its reputation, its expertise, the themes it focuses on and the relation to the investors' own approach.

A point worth highlighting is that institutional investors are generally going further than standalone ESG ratings, by (i) developing their own ESG research and/or by (ii) developing an in-house assessment tool with their own impressions about sustainability performances of companies. This is in line with recommendations found in the academic review around the integration of ESG into investment decisions (Bos, 2020). It also lowers potential biases and discrepancies in the ratings. However, this internal expertise or "double check" is generally not accessible to investors with scarcer resources.

### 8.1.2. Pitfalls and precautions

We have seen in the literature review that many drawbacks appear in the way ESG ratings are built and integrated. These aspects were further explored during the interviews, by understanding the use of this tool and its numerous disadvantages. We will also examine how investors try to cope with those limitations.

Relatively to the third chapter and to the landscape of the sustainability ratings market, we observed that various methodologies are employed by rating agencies. This spread confusion among institutional investors, because they find that the way ESG ratings are built is not transparent enough. If one of them is truly willing to delve into the methodologies, they will experience how daunting that task is. This difference in methodology largely explains the discrepancies in the ratings. Many institutional investors have already observed the ratings were sometimes giving divergent results. To counter that, the largest among them do not hesitate to turn to multiple rating agencies to limit the bias. However, subscribing to many ESG ratings providers could quickly become too costly for smaller players.

Drawbacks related to firm size bias (Chatterji, Durand, Levine, & Touboul, 2016) were shared during the interviews. For this reason, some institutional investors have decided to rely on ESG ratings mainly for larger capitalization and global companies.

Speaking of the provenance of ESG data, respondents mentioned that sustainability ratings carry with them a certain delay, because they are based on corporate annual reports. However, some have severely disagreed with this standpoint, highlighting that ESG ratings represent the sustainability state of companies, which does not vary every week (e.g. carbon emission, gender parity). In any case, AI and technological tools are emerging, as proven by many stakeholders subscribing to TruValue Labs. This confirms an intuition in the literature review, i.e. Big Data will become increasingly important and crucial for investors (Serafeim, 2018).

An additional point of criticism, although hardly met in the literature review, relates to the amount of companies which need to be covered by analysts. This translates into a surface analysis that does not always reach the stage of an in-depth sustainability assessment. This may also be seen as a shortfall of expertise for  some regions or industries. This is particularly the case in the Nordics. In that region, we have identified a clear lack of knowledge on the companies, on the history that has carved them throughout the years and on the peculiarities of recognized industries such as fisheries and aquaculture.

Even though all the actors interviewed have the means to subscribe to at least one ESG ratings provider, some complain about the high expenses they have to incur. Even larger and wealthier players cannot collaborate with an indefinite number of rating agency, because of their budget constraints. Hence the need to correctly choose the rating provider, alongside investors' own preferences.

Eventually, several interviewees shared their deep concerns about the shortcuts taken by some other investors. Indeed, some claim that they do invest responsibly by simply integrating ESG ratings, without any value-based judgement.

### 8.1.3. Further improvements

Throughout this paper, we have witnessed a large evolution of the ESG ratings market through consolidations. Living proof of the constant dynamism of the sustainability ratings and research market is what happened in the first months of this year. Indeed, while writing this paper, S&P acquired the rating arm of RobecoSAM (January 2020), and Morningstar acquired full stakes of Sustainalytics (April 2020, right before starting the interviewing process). These mergers and acquisitions bring more capabilities and skills to the market, but at the same time decrease its competitiveness. Whether ESG ratings will increase in validity trough joint expertise is precisely an open question within the literature, (Chatterji, Durand, Levine, & Touboul, 2016). This is also a subject of interest for contacted institutional investors.

The two largest asset managers interviewed strongly insisted on the fact that one of the biggest issues in the evolution of the ESG ratings market is that it could become an American oligopoly, just as in the financial market. According to AXA, sustainability investing has developed in Europe, and the Old Continent should remain the leader in that field.

Investors also expect improvements in terms of transparency in this ESG ratings market, as they preach to rating agencies. This was also mentioned in the literature as a piece of advice to enhance the ESG ratings market. Some believe that sustainability ratings might be improved by future disclosure regulations launched in Europe. The *do's and don'ts* from the European

Commission are under an increased scrutiny by investors. The sustainable finance taxonomy, further strengthened by the European Green Deal, should have impacts on ESG ratings.

To summarize, ESG ratings are indeed necessary for institutional investors, as they help them reaching high levels of responsible investments. The largest asset managers in Europe have announced that they would only make investment decisions aimed at transiting to a sustainable economy. However, as the literature review underlined, caution should be paramount in using the opinion of third parties to base one’s investments decisions. Overall, it seems that ESG ratings and research have the power to dictate which company is actually contributing to a future-proof economy.

## Section 8.2. Contribution to management

As it has been repeated throughout this paper, ESG ratings are an insightful way to quickly form one’s opinion on sustainability credentials of a firm. We believe the results of this master thesis should give credit to the usefulness of ESG ratings and their utilization by institutional investors in Europe. This research may help investors making more thoughtful and sound investment decisions. By explaining the various drawbacks of sustainability ratings and by putting in place careful checks, this work can help investors understand how to cope with the limits these ratings imply. If investors are relying on ESG ratings as shortcuts for responsible investments, it may lead to counter-intuitive results, misallocating trillions of capital. We thus advise investors to carefully go through the methodology of the ESG ratings providers on the market, in order to select the one(s) truly in accordance with their preferences and values.

This paper may be useful for policy-makers, especially for the European Commission. Indeed, the results demonstrate the large extent to which ESG ratings are used and the confusion they spread not only among institutional investors, but also among companies and managers.

Although extensively illustrating the limitations of this sustainable investment tool, the results also give some hope as to leave more room to improve ESG ratings. We advise investors to foster discussion with rating agencies, pushing for more transparency and clarity on their methodology. Discussion is indeed required to make this tool evolve in the right direction. For ESG investing to become mainstream, investors should take part in the changing of the narrative.

# Part 5 Conclusion

On the 12th of February 2020, Steven Maijoor, chair of the European Securities and Markets Authorities (ESMA), declared during the European Financial Forum: "I also want to mention ESG ratings, as they are becoming increasingly important, but the level of public scrutiny and supervision of them, in my view, is far from optimal. The lack of clarity on the methodologies underpinning those scoring mechanisms and their diversity does not contribute to enabling investors to effectively compare investments which are marketed as sustainable, thus contributing to the risk of greenwashing" (Maijoor, 2020).

This statement casts doubts on the relevance of ESG ratings for investors, feeding the research question we attempted to address: "*What is the value of ESG ratings for responsible investors in allocating capital towards sustainable companies?"* To answer this question, and after going through the role of ESG ratings within sustainable finance, the paper lifted the veil on the types of providers and on the needs it fulfills for investors and companies. In a following step, we examined the state of play of the ESG ratings market in Europe, delving into the methodologies of the main players. This follows a research launched by the European Commission in fall 2019. We closed the academic research by pointing out the drawbacks faced in integrating those scores. In view of a hands-on analysis of the value of ESG ratings, we later proceeded with elite interviews to nine European institutional investors and aimed at understanding the necessity of ESG ratings, the criteria for choosing providers, and the precautions taken to counter the limitations of this tool.

This process was insightful to understand the value of ESG ratings for institutional investors. In Europe, most investors are integrating ESG ratings to save money and time, by avoiding internal researches. ESG ratings are mainly used for screening purposes, only a few make them a rule of thumb and the majority complement them with in-house expertise. Certain investors are taking precautions, notably by subscribing to several providers, conscious of the many pitfalls using ESG ratings implies, such as divergences in the ratings, firm size bias, and time lag. Some others are counting on other third parties, offering technological advances such as Artificial Intelligence. Putting our results into perspective, this research is showing that the value of ESG ratings is as high as the caution devoted to their use. In order to allocate capital towards sustainable companies, most investors find it necessary to ask help to third parties.

However, everyone should reflect upon choosing the right ESG ratings provider(s) in accordance with their preferences and their needs, by carefully exploring their methodologies, and by fostering a genuine dialogue with rating agencies. The study has also put forward that subscribing to an ESG rating provider and declare oneself leader in responsible investing, is not enough to foster a future-proof economy. Investors should understand the underlying consistencies of ESG ratings. To conclude, the limitations of sustainability ratings should not be overwhelming to the point of being detrimental to a sound willingness to transit to a sustainable future.

## Limits and further research

It is interesting to reflect upon our findings, including their limits. By nature, biases are introduced in a qualitative research strategy, as reproducibility of results with other interviewees are not possible (Bryman, 2012). However, we tried to minimize this potential drawback by interviewing a panel of nine investors, some small and some large players. To enhance reliability of the interviews, we used the triangulation methodology, by preparing questionnaires beforehand and by double checking the information with the UN PRI database (PRI, 2020a).

Another limit concerns the initial reservations that interviewees might have expressed about the scope of our questions. Indeed, they could fear our judgement on their responsible investment strategies, showing less openness in answering. To avoid a lack of transparency from respondents, we insisted at the start of the discussion that this research was about their use and opinion of ESG ratings, and not an assessment of their practices.

In this research, we were able to witness the lack of transparency in the market of ESG ratings. Indeed, our initial research strategy aimed at comparing several ESG ratings applied on companies in the same industry. The baseline for the comparative study was meant to focus on the Norwegian aquaculture industry. The main players in this global sector are located in Bergen and could have been the focus of a targeted case study. This would have compelled us to study the methodologies of the different third parties' rating, as well as the disclosure procedures of companies on material ESG issues. However, after contacting both rating agencies and companies in the seafood industry, this first idea lead to a dead end. After analyzing the interviews with institutional investors, we found out that the Nordic countries, and especially seafood firms, were not well known to ESG ratings agency. We thus advice future researchers to focus on industries or regions which are well covered in terms of sustainability assessments by ESG ratings vendors, such as the automotive industry for instance. Furthermore, we shall remind the reader that this thesis is written partly during the Covid-19 health crisis. Access to Bloomberg and Eikon (from Refinitiv) Terminals being restricted, compiling a proper comparative study became even more difficult.

Further research could be explored around ESG ratings, and we advise other studies to reflect on currently problematic areas. It would first be interesting to delve into the consequences of European regulations on the quality of ESG data. When it comes to the EC study, it could be interesting to investigate more deeply the evolution of credit or ESG rating agencies market. We would also recommend to focus on one particular financial product (e.g. green bond ratings which verify the alignment with the green bond principles). Eventually, other research could aim to understand the way ESG ratings and research are integrated into financial valuation of companies. It may help to understand if a relevant corporate ESG assessment impacts financial risks and returns.

In closing this paper, some may be concerned that the current health crisis could be an impediment for the European sustainability agenda. Quite the contrary, we are hopeful that the European Green Deal and the underlying sustainable finance taxonomy will stay on track. As mentioned during the IIF European Conference (Institute of International Finance, 2020) on the 27th of May 2020:

*"ESG will become absolutely mainstream after this, because we have tested that it is relevant. Sustainable finance has proven that it can actually serve its purpose, even in a time of stress, and isn't just a nice weather concept. I am very positive that it will actually lead to even greater focus."*

*– Daniel Klier, Group General Manager and Global Head of Sustainable Finance, HSBC Holdings plc.*

It certainly promises a long-lasting momentum for ESG ratings in the years to come.

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# Part 7 Appendices

**Appendix I.** 17 UN SDGs


***Figure 2*** *UN Sustainable Development Goals (United Nations, 2015).*

**Appendix II.** Bloomberg ESG Dashboard


***Figure 3*** *Bloomberg Terminal - ESG Dashboard (Bloomberg, 2019).*

**Appendix III.** UN PRI signatories' commitment

"As institutional investors, we have a duty to act in the best long-term interests of our beneficiaries. In this fiduciary role, we believe that environmental, social, and corporate governance (ESG) issues can affect the performance of investment portfolios (to varying degrees across companies, sectors, regions, asset classes and through time).

We also recognize that applying these Principles may better align investors with broader objectives of society. Therefore, where consistent with our fiduciary responsibilities, we commit to the following:

**Principle 1**: We will incorporate ESG issues into investment analysis and decision-making processes.

**Principle 2**: We will be active owners and incorporate ESG issues into our ownership policies and practices.

**Principle 3**: We will seek appropriate disclosure on ESG issues by the entities in which we invest.

**Principle 4:** We will promote acceptance and implementation of the Principles within the investment industry.

**Principle 5**: We will work together to enhance our effectiveness in implementing the Principles.

**Principle 6**: We will each report on our activities and progress towards implementing the Principles.

[…]

In signing the Principles, we as investors publicly commit to adopt and implement them, where consistent with our fiduciary responsibilities. We also commit to evaluate the effectiveness and improve the content of the Principles over time. We believe this will improve our ability to meet commitments to beneficiaries as well as better align our investment activities with the broader interests of society.

We encourage other investors to adopt the Principles." (PRI, 2020b).

**Appendix IV.** Map of the state of play in the ESG ratings market

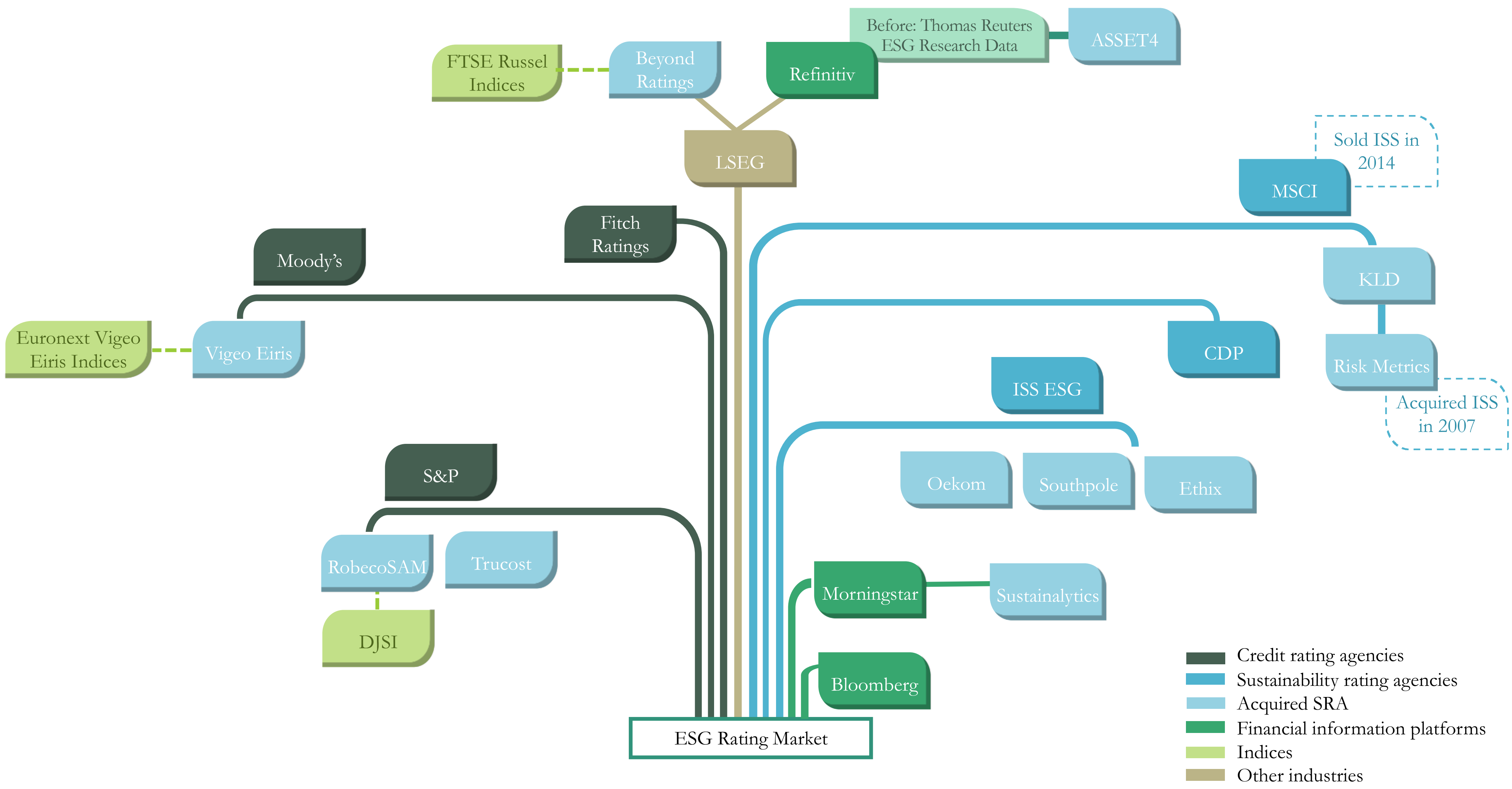


***Figure 4*** *Landscape of the ESG rating market. CDP = Carbon Disclosure Project, ISS = Institutional Shareholder Services, KLD = Kinder, Lydenberg, Domini Research & Analytics , DJSI = Dow Jones Sustainability Indices, S&P = Standard & Poor's, MSCI = Morgan Stanley Capital International, LSEG = London Stock Exchange Group, GES = Goh Electronics Services International.*

## **Appendix V.** Interview guide

| | **WARM UP QUESTIONS** |
|---|---|
| | Objective of the thesis – My objective is to draw a state of play of the ESG ratings market, and its strong evolution, through consolidation and above all understanding why there are differences in ESG ratings between various providers. I am interested in understanding the use and the critics from institutional investors. |
| 1. | May I ask you to briefly introduce yourself and your role at the firm? |

| | **ESG INTEGRATION METHODOLOGY** |
|---|---|
| 2. | What is your own approach to ESG? |

| | **INTEGRATION OF ESG RATINGS WITHIN INVESTMENT DECISIONS** |
|---|---|
| 3. | How would you describe ESG ratings, and how important are they in the sustainable investing community? |
| 4. | How are ESG ratings integrated into your investment decisions and strategies? How useful are they? |
| 5. | Are you using ESG ratings as you receive them, or do you integrate them in an in-house rating by combining them with other criteria? |

| | **RATING PROVIDERS, SPECIALIZED AGENCIES, DATA PROVIDERS** |
|---|---|
| 6. | With which rating providers are you currently working, and what are the criteria behind your choice? What makes them more valuable than others? |
| 7. | Do you make use of the Bloomberg or Refinitiv terminals for ESG information or Sustainable indices? |
| 8. | Do you see a role for Credit Rating Agencies in this market? |

| | **CRITICS OVER ESG RATINGS** |
|---|---|
| 9. | What are the main challenges from ESG ratings? |
| 10. | What precautions are you taking, if any, when using ESG ratings? |
| 11. | There are more and more consolidations in this ESG ratings market. Does it concern you, or do you think it is a good sign? |

| | **DISCREPANCIES** |
|---|---|
| 12. | According to you, what does explain that ESG ratings differ between providers? |

| | **OPINION ON THE FUTURE OF ESG RATINGS** |
|---|---|
| 13. | Which measures or actions would you like to see in ESG ratings in the next years? How should ESG ratings be improved in the years to come? |
| 14. | Do you think that ESG ratings should be regulated by public sector authorities ? |
| 15. | Are ESG ratings key to transit to a more sustainable future? |
| 16. | In your opinion, what will be the future of ESG ratings, in 5 years' time from now? |

## **Appendix VI.** Profile of the interviewees

| *Institutions* | *Type of Institution* | *AuM[15] (in € or NOK)[16]* | | *Country* | *Position of the interviewee* | *Interview Date (2020)* | *Transparency report (Yes/No)* |
|---|---|---|---|---|---|---|---|
| | | *Total* | *ESG / RI* | | | | |
| *Amundi* | Asset Management | €1.527tn | > €320bn | France | Head of Responsible Investment | May 13th | Yes, signatory since 2006 |
| *AXA Investment Manager* | Investment Management | €801bn | €508bn | France | Global Head of Impact Strategy and Responsible Investments | May 20th | Yes, signatory since 2007 |
| *BNP Paribas Fortis* | Asset Management | €1.123bn | €47bn | Belgium | Head of Sustainable and Responsible Investment | May 5th | Yes, signatory since 2006 |
| *Degroof Petercam Asset Management* | Asset Management | €54.7bn | €4bn | Belgium | Head of ESG research and Responsible Investment strategist | April 27th | Yes, signatory since 2011 |
| *Folketrygfondet* | Government Pension Fund Norway | NOK254.8bn[17] | | Norway | Portfolio Manager ESG | April 27th | Yes, signatory since 2009 |
| *Gjensidigestiftelsen* | Asset owner Financial foundation | Not available | | Norway | Portfolio Manager | April 29th | No, signatory since 2018 |
| *NN Investment Partners* | Investment Management | Total: €276bn | Not available | Netherlands | Responsible Investment specialist | April 30th | Yes, signatory since 2008 |
| *Orcadia Asset Management* | Wealth Management | Not available | | Belgium | Chairman and founder | April 29th | No, signatory since 2019 |
| *Triodos Investment Management* | Investment Management | €4.2bn | | Netherlands | Investment Analyst | May 8th | Yes, signatory since 2009 |

15 Asset under Management.
16 Most recent public numbers retrieved online.
17 As market value.

## Sources for number of AUM in Appendix VI.

- Amundi Asset Management's website. Numbers as of March 31st, 2020, for the total AUM, and as of December 31st, 2019, for responsible investment AUM (Amundi Asset Management, 2020).
- AXA Investment Managers' website. Numbers as of December 31st, 2019, for the total AUM, and for responsible investment AUM (AXA Investment Managers, 2020).
- BNP Paribas Private Banking. Numbers for the International Financial Services of the entire Group (and not the Belgian subsidiary only). As of December 31st, 2019 for the total AUM, and as of September 31st, 2019 for the Socially Responsible Investment fund managed by BNP Paribas Asset Management (BNP Paribas, 2020).
- Degroof Petercam's 2018 annual report. Numbers as of 2018, for the total AUM, for responsible investment AUM (Bank Degroof Petercam, 2018).
- Government Pension Fund Norway (GPFN). Market value as of June 30th, 2019 (Regjeringen.no, 2019).
- NN Investment Partners' website. Numbers as of December 31st, 2019, for the total AUM (NN Investment Partners, 2020)
- Triodos Investment Management. Numbers retrieved from the interview.

**Appendix VII.** Integration of ESG ratings within the responsible investment approach

| *Institutions* | *ESG Incorporation Approach (from PRI transparency reports and interviews)* | | | | | | *Use of ESG Ratings* | *ESG Ratings Integration* | *Reasons for using ESG ratings and research* |
|---|---|---|---|---|---|---|---|---|---|
| | *Negative screening* | *Best-in-class screening* | *Active ownership* | *Thematic Investing* | *Impact investing* | *ESG Integration* | | | |
| *Amundi* | x | x | x | x | | | Yes | - For own in-house ESG scale<br>- Aggregated final score | - Covering 10,000 values, no internal capabilities |
| *AXA Investment Manager* | x | x | x | | x | x | Yes | - For in-house rating system<br>- Raw data, select the most useful information | - Discover new sources<br>- Guide investors through risks |
| *BNP Paribas Fortis* | x | x | x | x | | x | Yes | - Integrate in evaluation process<br>- Using raw data within in-house tool, own scoring | - Understanding ESG funds composition<br>- Double check |
| *Degroof Petercam Asset Management* | x | x | x | x | x | x | Yes | - Analysts have access to ESG scores and research<br>- Systematic use for eligible universe<br>- Used as a very first screening | - No internal capabilities, mandatory to buy ESG research and ratings<br>- For Belgium labels, requirement to use them |
| *Folketrygfondet* | x | | x | | | x | Not anymore | | |
| *Gjensidigestiftelsen* | x | x | x | x | | | Yes | - Decomposition in pillars<br>- For screening approach | - Related to investment criteria |
| *NN Investment Partners* | x | x | x | | x | x | Yes | - Raw ESG data integrated into own in-house tool<br>- For screening approach | - Insightful inputs |
| *Orcadia Asset Management* | x | x | | | | | Yes | - Most investments based on ESG ratings exclusively | - Understand the basis of indexed fund |
| *Triodos Investment Management* | x | positive screening | x | | x | | Yes | - Within three stages investment process, identify eligible companies | - For internal processes<br>- More demands from shareholders and clients |

**Appendix VIII.** Criteria for selecting ESG ratings providers

| *Institutions* | *Sustainability Rating Agencies* | *Criteria or reasons for selection* | *Sustainable Indices* | *Criteria or reasons for selection* | *Financial information platforms* | *Criteria or reasons for selection* |
|---|---|---|---|---|---|---|
| *Amundi* | **Sustainalytics, MSCI, Vigeo, ISS** | Expertise, coverage, themes | **MSCI** | Use them to create their own indices | **Bloomberg** | For passive funds, in order to create ETFs and index funds |
| | **Factiva, RepRisk** | Track controversial issues | | | | |
| | **ISS-Ethix** | Securities involved in weapons | | | | |
| | **Trucost** | Environmental issues | | | | |
| *AXA Investment Manager* | **MSCI** | Different backgrounds, coverage | NA | NA | **Bloomberg** | ESG information sometimes checked on the terminal |
| | **Oekom Sustainability** | | | | | |
| | **Vigeo Eiris** | | | | | |
| | **Sustainalytics** | | | | | |
| *BNP Paribas Fortis* | **MSCI** | More analysts | **MSCI Indexes**<br>**DJSI**<br>And others | Good reputation, working well | **Morningstar**<br>**Bloomberg**<br>**Refinitiv** | Other type of info available<br>Depending on clients' demands |
| | **Vigeo** | Coverage | | | | |
| | **Sustainalytics** | More quants | | | | |
| | **Trucost** | Environment<br>CO2 metrics | | | | |
| *Degroof Petercam Asset Management* | **Sustainalytics** | Coverage, personalization | **MSCI Indices** | Own range of products linked to MSCI ESG indices | **Bloomberg** | When possible, use of the terminal |
| | **MSCI** | Coverage, basis for indices | | | | |
| | **Trucost** | Environmental metrics | | | | |
| *Folketrygfondet* | **No** | | **No** | | **Bloomberg** | Reliable and timely data<br>ESG controversies newsletter |
| *Gjensidigestiftelsen* | **MSCI** | Relation to financial criteria, easier to dismantle | **No** | | **Bloomberg** | Business Intelligence <BI ESG><br>ESG data developed |
| *NN Investment Partners* | **Sustainalytics** | Dutch company, number one before, event scores (1-5) | **No** | | **Refinitiv** | Good on 'E' and 'G', data from annual reports |
| | **ISS Ethix** | Large player | | | **Bloomberg** | Not using it, figures based on annual reports |
| | **MSCI** | Large, coincidence | | | | |
| | **Green17** | SDGs specialists, niche | | | | |
| | **TruValue Labs** | Big data, timeliness | | | | |

| | | | | | | |
|---|---|---|---|---|---|---|
| *Orcadia Asset Management* | **MSCI** | Best reputation, global player, better quality in terms of responsible methodology | **MSCI ESG**<br>**MSCI SRI** | Replicate MSCI analyses<br>Renowned for Stock indices | **Bloomberg** | Double check: Sustainalytics, RobecoSAM |
| *Triodos Investment Management* | **ISS ESG** | Comprehensive, impact investing, in-depth | **No** | | **Bloomberg** | |
| | **TruValue Labs** | AI, controversies signals | | | | |

**Appendix IX.** Limitations and challenges from ESG ratings

| *Institutions* | *Critic 1: Methodologies* | *Critic 2: Divergence in ratings* | *Critic 3: Data provenance* | *Critic 4: Integration of materiality* | *Critic 5: Firm size bias* | *Other critics* | *Precautions taken* |
|---|---|---|---|---|---|---|---|
| *Amundi* | - Black box | - ≠ indicators for the same criteria<br>- No standardization | - Raw ESG data provided by rating agencies | - Don't integrate everything (e.g. lobbying rate) | | | - 9 data providers<br>- Identify bias in house<br>- Big data |
| *AXA Investment Manager* | | - Brings confusion | | | | - Backward looking<br>- Not updated fast enough | - 4 different providers limiting the biases |
| *BNP Paribas Fortis* | - Methodology to create ratings & indices ≠ | - Measurement divergence (≠indicators for same criteria) | | | | - Too expensive for small players | - Using 5 providers to double check the data<br>- Dialogue with firms |
| *Degroof Petercam Asset Management* | - Lack of transparency | - How companies are defined related to their peers. If relative scores defined differently, discrepancies in scores | - Conflict of interests from questionnaire-driven scores (e.g. DJSI) | - Miss real issues in specific themes (fisheries, food)<br>- MSCI dictates what they find important | - Firm bias | - Passive management worrisome when using ESG ratings without critical thinking (funds, indices, etc.)<br>- Qualitative comments ≠ | - Critical spirit<br>- Challenge rating providers to enhance more reliable research<br>- Adjustments |
| *Folketrygfondet* | | | | - No expertise on Nordic countries | | - No variation in the Nordics<br>- Too many firms by analyst | |
| *Gjensidigestiftelsen* | - Mechanical<br>- Hard to understand their approach | - Low correlation | | - Miss real issues in specific themes (fisheries, salmon)<br>- Subjective | | - Low coverage in Norway<br>- Not proactive with companies<br>- Too expensive | - Adjustments in function of own knowledge |
| *NN Investment Partners* | - Not transparent enough | - Different methodologies | - Only on annual reports, time lag | | - Firm bias | - For impact investing, beyond ESG ratings<br>- Criticism over its utilization<br>- Too expensive | - In-house tool "ESG Assessment Framework" |
| *Orcadia Asset Management* | - Lack of transparence | - Questioning | | - Choice that are not theirs<br>- Not linked with investors' preferences (+ biased) | | | None, don't think they are better than MSCI |
| *Triodos Investment Management* | - Hard to understand deep down | - Variance in methodology<br>- Not factual data | - Annual reports | | | - Backward looking<br>- Too many firms by analyst | - In-house research<br>- External raw data<br>- AI (TruValue Labs) |

**Appendix X.** Opinion on the future of ESG ratings

| *Institutions* | *Evolution and consolidations* | *CRA role in ESG investments* | *ESG ratings improvement* | *Future outlook and challenges of ESG ratings* |
|---|---|---|---|---|
| *Amundi* | - Bad news, because if American firms give their opinion, they give their own vision | - Consolidation of this market through CRA | - Raw ESG data by corporates, and rating agencies only qualitative analysis<br>- Should integrate other components<br>- Increasing corporate disclosure | - 2021 own target of 100% investments filtered by ESG criteria, thanks to ESG ratings |
| *AXA Investment Manager* | - Less discrepancies and variance<br>- Risky to have an American oligopoly | - Attractive market for them, because profitable<br>- Not truly embedding ESG | - Integration of real-time data<br>- Quality will get better<br>- Regulations will put pressure on firms | - One of the biggest hope: that ESG continues to be led by Europe |
| *BNP Paribas Fortis* | - Good: more means, increase capabilities<br>- Bad: must stay independent | | - Too many. Norms and standards needed<br>- More proactive in marketing<br>- More transparent for the clients | - Becoming mainstream<br>- Credit ratings automatically supplemented by ESG rating? |
| *Degroof Petercam Asset Management* | - Consolidations worrisome, decrease the critical spirit<br>- More and more dependent on big players | - More experience in process structures<br>- More transparent and mature<br>- Probably in the future | - More and more regulations to standardize this market<br>- Integrate smaller companies | - ESG ratings and research have the power to dictate which company is sustainable |
| *Folketrygfondet* | - Might help to become more professional<br>- BUT bad for competition | - Can have a role, only if you have a large investment universe<br>- Not a lot in the Nordics | - Coverage expansion | |
| *Gjensidigestiftelsen* | - Good for more transparency, makes ESG more mainstream<br>- No need to get data from many providers | - Increasing role. Important in credits to integrate all risks | - Standardization (EU taxonomy)<br>- More transparency<br>- Price cut | - ESG ratings and research have the power to dictate which company is sustainable |
| *NN Investment Partners* | - Not a good development, less reasons to innovate<br>- More pricing power | | - Standardization from EC<br>- More transparency<br>- More timeliness | - ESG ratings easy to use: greenwashing from certain investors |
| *Orcadia Asset Management* | - Monopoly and duopoly worrisome<br>- Important to have competition | | - Should be more evolutive, by integrating tax optimization e.g.<br>- EC will regulate the market | - A great future for ESG ratings (won't be challenged before a long time) |
| *Triodos Investment Management* | - Better IT, skills, more professional, organized<br>- Critics: should not become a sweatshop for the analysts (better work life balance) | | - Using AI and more technologies to track controversies in a timely way | - EU standards: lots of politics, hurdles for labels are too low |

**Appendix XI.** Transcripts of interviews [CONFIDENTIAL]

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