The GRI Perspective

The ABC of ESG ratings – an invitation for common ground

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With heatwaves, virus variants and multiple global crises, the sustainability movement and its integration into everyday aspects of organizational operations and financial markets does not seem to stop. Much of the recent attention has been on standards to achieve a global baseline for sustainability reporting, yet one player influencing the corporate sustainability ecosystem seems to go under the radar: ESG rankers and raters.

In the drive for transparency in the investment sector, the role of rating agencies should not be misunderstood. These rankings may be useful to many but remain a mystery to most. It is time to look into the 'A-B-C' of ESG ratings.

A. Lifting the lid on the world of ESG ratings

With accusations of being subjective or inconsistent, the perception of ESG rankers and raters is not always in a positive light. This is understandable when you realize that many organizations are actively managing the various sustainability ratings they obtain from various agencies, given they influence finance flows. **Not only are ratings used to benchmark, inform shareholder decisions or assess supply chain information, they can improve disclosures, attract capital and manage the brand**. Moreover, ESG ratings feed into index construction of the various ESG Exchange Traded Funds that investors are heavily embedded in.

By their nature, rating services are a key component in financial markets, reducing research efforts by fund managers to find potential investments, flagging areas of concerns, and used as basis for engagement in responsible investment strategies.

To better understand the market, it can be divided as follows:

1. Credit Rating Agencies - players that have been around for decades and often have an official status from market authorities (such as Fitch, Moody's, S&P, Morningstar/Sustainalytics);
2. Benchmark or index administrators (like MSCI and FTSE Russell);
3. Data vendors (such as Bloomberg and Refinitiv)
4. Specialized firms – providing rating services for specific aspects and market segments (for example, Eco Vadis and RepRisk).

However, these boundaries are more fictitious than absolute, with cross-cutting activities in many organizations. And as *KMPG research has found*, there are (at least) 150 of these agencies on a global scale.

As provider of the world's most widely used sustainability reporting standards, GRI is not in the ranking and rating business. However, GRI works closely with these organizations as they are key stakeholders in providing their subject matter expertise through our standard setting due process and public consultations. In addition, the metrics obtained from GRI reports offer essential data points, which these agencies are starting to build into their methodologies. Increasingly, information from GRI reporters will serve as a basis for their conclusions.

B. A need for consistency in ESG data

Creating ESG ratings is not an easy task. Why? First, the data behind it is complex. The term ESG reveals it all: a ranking will consist of three big chunks of information covering environmental, social and governance aspects. Agencies analyze hundreds of topics, attaching weightings to them to come to a conclusion. Secondly, there is not one ESG rating, as providers have multiple products for multiple purposes and audiences. Thirdly, data availability. Reporting on sustainability is still quite new to many organizations and is constantly evolving. On top of that, many companies use various standards and disclosure frameworks. If companies cannot provide the requested information, ratings firms often 'impute' it, i.e. fill the data gaps based on assumptions provided by their sophisticated models.

With agencies assessing thousands of companies across a broad range of ESG topics, assigning them with a score or rank, inconsistencies in and between the rating of companies are bound to happen. Public scrutiny demands (such as happened *recently with MSCI*) are therefore no surprise. There is increasing attention on the ESG ranking industry, with financial watchdogs c*alling for more regulation*. Several have already issued opinions, such as the *US-SEC*, *ESMA* and *IOSCO*. The *European Commission* goes one step further and is currently consulting on proposed ESG rating regulations, as part of the EU Green Deal.

C. What do ESG ratings rate?

It is with this question that the confusion starts: what do ESG ratings actually stand for? Do they measure a company's sustainability risk or its impact? Broadly speaking ESG ratings only look at 'risk' and therefore focus on financial materiality. Sustainable development, however, has two sides, for which you also need impact materiality. In other words, with very few exceptions, ESG ratings measure a company's exposure to (industry-specific) sustainability risks and how well it manages them.

What this means is that **users need to understand that ESG ratings do not necessarily measure whether a highly rated company is a leader in reducing its socio-economic and environmental impact, and thereby contributing to a more sustainable world**. It is highly debatable whether *ratings that focus on risks alone can be a proxy for impact*. The agencies realize this, which is why there is movement towards not only ESG risk but also impacts being incorporated into the methodologies. But we are certainly not yet there.

Progress to a common baseline for ESG disclosure

As the entire sector around sustainability standard setting, reporting, data collection and assurance is professionalizing and increasingly regulated, the way of working for rating agencies is bound to change. And this is good news, especially when it comes to data. **The global corporate sustainability reporting baseline is currently being** *shaped in collaboration* **between GRI and the IFRS Foundations' International Sustainability Standards Board (ISSB)**, which will allow agencies to draw on a single set of information to subtract data from.

This interacting reporting baseline will seek to build on the existing structure of both financial accounting standards (IFRS/FAS) and the GRI Standards, which already offer a tested proof of concept for more than 20 years, used by 11,000+ organizations. This will not only give clarity in a fragmented reporting landscape but limit the cost of compliance – and provide comparable data for stakeholders, including rating services.

The upcoming ISSB standards focus on 'enterprise value creation', capturing the inward influence. The GRI Standards, on the other hand, fully address an organization's outward impacts – across environmental, economic, and social dimensions. Taken together this provides rating agencies with metrics on both sustainability risks and impacts. **By closing the loop and making use of the metrics provided by GRI and the ISSB, the information ecosystem will be streamlined – allowing reporters, data users and other market participants to see eye-to-eye on ESG ratings**.

Of course, the methodologies and calculation models will continue to differ, and agencies can add extra metrics or attach different weights to them, but that is the key of the trade. Changes to ensure consistency in the ESG data and sources used, and transparency on how it is applied, is what matters.

Global baseline – set of information

Pillar 1
Strengthened financial reporting
Focus: financial implications of sustainability issues on enterprise value creation

Double materiality

Pillar 2
Impact reporting
Focus: impacts a company has on the environment, society and the economy.

Outside in

Financial materiality
The financial effects of sustainability issues on enterprise value creation

+

Impact materiality
The impact of corporate behaviour on the environment, society, and the economy

Inside out

Data

ESG rating

Bloomberg, ecovadis, FitchRatings, FTSE Russell, ISS, Moody's, Morningstar, MSCI, Refinitiv, RepRisk, S&P Global, Sustainalytics

Plus numerous other organizations

How we can help

We recognize that effectively using the GRI Standards requires support. The *GRI Academy* offers specific training on the GRI Standards, including the 2021 update of the Universal Standards that come in to effect for all reporting from January 2023. You can also keep up to date with *GRI events* that cover policy engagement, standards developments and more. Learn more about the full range of *GRI's services and tools* that are here for you.

Our ask

We are an international non-profit organization that reflects multi-stakeholder interests by developing and setting world-class sustainability reporting standards.

Our standards are free to use, but not free to develop. Creating and maintaining standards is time and resource intensive. To enable us to keep up the good work and stay on the leading edge of corporate sustainability reporting **we need your support!**

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