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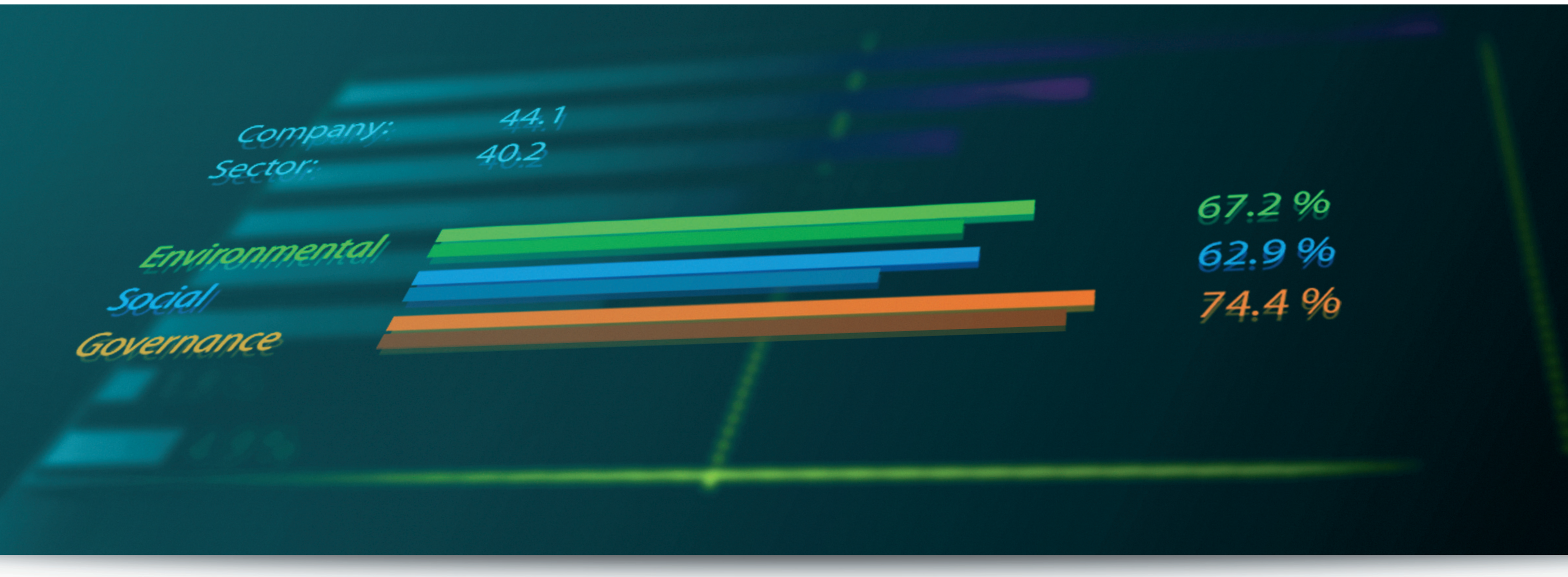

The opportunities and challenges of sustainability ratings and rankings

econsense discussion paper

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econsense is an association of leading, globally active companies and organisations of German business specializing in the area of sustainable development and corporate social responsibility (CSR). Founded in 2000 on the initiative of the Federation of German Industries (BDI), the goal of econsense is to provide a dialogue platform and think tank, with the dual objective of advancing sustainable development in business and assuming social responsibility.

Members:

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[1] 1st edition March 2007, 2nd edition May 2008, 3rd edition March 2009. This updated version is based on discussions with experts from companies as well as the providers of sustainability ratings and rankings.

Executive Summary

Companies, investors and policy makers face the challenge of turning principles such as sustainability, corporate (social) responsibility (CSR or CR) and ethical/socially responsible investment (SRI) into tangible and credible actions.[2] Sustainability ratings and rankings can play an important role in this regard.[3] They function as intermediaries between companies and the financial markets by evaluating the sustainability performance of companies, and therefore influence investment decisions in favour of a sustainable development. The sustainability performance of companies is expressed by various aspects including material opportunities and risks associated with environmental, social and governance aspects (ESG).

The member companies of econsense have a fundamental interest in a transparent, efficient and valid evaluation of corporate ESG performance. However, this expectation has not always been satisfied in the past by the providers of sustainability ratings and rankings. This can be explained amongst other things by the complexity of the topic, the heterogeneity and competitive pressure in the market, as well as the business model of some providers. This paper therefore hopes to stimulate a dialogue between companies, the financial market, policy makers and society, to strengthen the quality, acceptance and impact of sustainability ratings and rankings.

The following suggestions summarise the improvement potential of the current rating and ranking practise from the point of view of econsense:

1. **Further improve the transparency and comprehensibility of sustainability ratings and rankings.**
2. **Apply the concept of "materiality".**
3. **Take account of the limits of comparability of legal jurisdictions, sectors and companies.**
4. **Boost the efficiency of working processes between raters, rated companies and investors/SRI-analysts.**
5. **Move towards a harmonisation of sustainability ratings and rankings.**
6. **Take appropriate account of the business potential associated with ESG activities.**
7. **Intensify the dialogue between raters, rated companies and investors.**
8. **Clearly separate sustainability ratings and rankings from other services.**

Why is the sustainability performance of companies evaluated in the first place?

Sustainability ratings and rankings assess and compare the sustainability performance of companies, which is expressed amongst other things in material opportunities and risks associated with environmental, social and governance aspects (ESG). These instruments play an increasingly important role in the valuation of companies on the financial markets. More and more market players are interested in the ESG performance of companies. Numerous sustainability funds and indexes have been launched in recent years. This development is on the one hand owed to the growing awareness amongst investors that "extra-financial" indicators such as ESG performance influence long-term corporate performance.[4] In addition, civil society stakeholders have come to the realisation that investors are an important vehicle for spreading sustainability in the business world, and therefore exert pressure on the players accordingly.

Numerous forums and initiatives have been established in recent years in which the financial industry and their stakeholders address the opportunities and challenges of ethical and socially responsible investment (SRI). This includes the "Enhanced Analytics Initiative" initiated by a number of large institutional investors; the "Who cares wins" initiative of the UN Global Compact; and the "European Sustainable Investment Forum (Eurosif)". A growing number of investors also support global initiatives such as the "UN Principles for Responsible Investment (PRI)" and the "Carbon Disclosure Project (CDP)". After demonstrating dynamic growth in recent years, these initiatives now cover a substantial share of the global institutional investment volume.[5]

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[2] The term (corporate) sustainability means that companies run their core business economically successfully as well as environmentally and socially responsibly. The term CSR or CR can describe environmental and social responsibility involved in the core business of a company, as well as activities which take place outside the core business (e.g. sponsoring or volunteering). Ethical/ socially responsible investment (SRI) bases investment decisions on both conventional profitability metrics and additional environmental, social and governance criteria.

[3] A credit rating is the evaluation of a company (or a country) in terms of its creditworthiness. Sustainability *ratings* evaluate the ESG performance (environment, social, governance) of companies, while sustainability *rankings* rank companies according to the quality of their ESG activities.

[4] Current (Meta) studies look in a differentiated way at the connection between ESG and market/financial performance of companies. A clear advantage has been demonstrated for "sustainable" companies, particularly in terms of capital costs. See for instance DB Climate Change Advisors (2012): Sustainable Investing – Establishing Long-Term Value and Performance (www.dbcca.com).

[5] UN PRI (www.unpri.org); Carbon Disclosure Project (www.cdpproject.net).

However, these developments cannot close our eyes to the fact that there has still been no fundamental paradigm change in the financial markets. Sustainable investment strategies in a narrow or broad sense[6] continue to remain a niche market, whilst the integration of sustainability criteria in the mainstream of the financial market still remains in the starting blocks.[7] Amongst other things this is due to the existing uncertainties and differences of opinion on the relevance of ESG for corporate performance.[8] Because of their reciprocal relationship with the financial markets, companies also have an obligation here: they have to develop compelling ESG business cases and communicate them appropriately.

Who evaluates corporate sustainability performance?

In recent years and decades a new market of information service providers has evolved for the evaluation of corporate ESG performance on behalf of investors, financial institutes and related parties.

The market for **sustainability ratings** is a playing field of specialised agencies, financial institutions, pension fund analysts, and index providers. Also the classic credit rating agencies are increasingly involved in expanding their range of activities toward integrating sustainability aspects. The full integration of sustainability and credit ratings is, however, slowed down by the lack of standardisation and reliability of data as well as the modest level of interest in the financial markets.

Whilst classic credit rating enjoys an established role in the financial markets and is dominated by few providers, sustainability rating is still a relatively young market: it is very dynamic, still only poorly regulated, and characterised by numerous providers with different business models and methods. Of 108 providers identified as relevant players at the end of 2010 by SustainAbility, only 21 have existed in 2000.[9] The heterogeneity of the rating and ranking market has increased rather than decreased since then.

The market for sustainability ratings currently reflects a broad spectrum of data collection and analysis methods. The providers usually align their activities with international standards such as the OECD Guidelines for Multinational Enterprises or the ILO Fundamental Principles and Rights at Work. The collection and analysis of data varies from purely qualitative to quantitative approaches. The heterogeneity of methods – which is also frequently reflected in the results – mirrors the fact that no generally accepted set of ESG metrics and evaluation methods have so far become established. In fact, some providers use their individual approaches as unique selling propositions in the market.

In the recent past, initiatives have evolved aimed at harmonising sustainability rating methods (e.g. Global Initiative for Sustainability Ratings).[10] Promising approaches are also observed with regard to the quality management of sustainability ratings. For instance, already in 2004 some leading European providers came together to form an umbrella organisation (AICSRR), and to develop a voluntary quality standard (CSRR-QS – Voluntary Quality Standard for Corporate Sustainability and Responsibility Research).[11] However, so far the impact of these initiatives has been modest: the CSRR-QS certification for instance has not been established throughout the market to date.

In addition to rating agencies and financial analysts, numerous consulting companies, scientific institutes and media houses have also become involved in the evaluation and comparison of corporate ESG performance. The findings are then published in the form of **sustainability rankings** which attract the attention of a broad public. Some rankings differentiate between the size of a company, others according to sector or country of origin. Some rankings use a broad mix of indicators to rate corporate ESG performance, whilst others exclusively focus on the evaluation of external sustainability reporting.[12] The results are mostly published in newspapers and business magazines, and therefore gain considerable public attention.

Sustainability rankings offer opportunities as well as risks. When companies go the extra mile in their commitment to social wellbeing or the interests of their own employees, it is desirable to see this reported in the media and made public for customers as well as investors. However, the fact that not all rankings in the market are based on the same degree of objectivity and rigorous methodology means that there is also a risk that misleading information gets published.

What are the challenges of the current rating and ranking practice?

As a network of major German-based multinational companies, econsense has been keeping a close eye on ESG ratings and rankings over the past years. The econsense member companies are in most cases the "objects" of ratings and rankings:

- They are directly affected when ratings are prepared because they have to put a great deal of effort into providing valid and detailed information.

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[6] Sustainable investments or SRI in a narrow sense ("core SRI") are based on standard and value-based exclusions and various types of positive screening. Investment in a broad sense ("broad SRI") is based on simple screening as well as commitment and integration strategies.

[7] Eurosif (2012): European SRI Study 2012 (www.eurosif.org).

[8] DB Climate Change Advisors (2012): Sustainable Investing – Establishing Long-Term Value and Performance.

[9] SustainAbility (2010): Rate the Raters – Phase Two (www.sustainability.com).

[10] Global Initiative for Sustainability Ratings (www.ratesustainability.org).

[11] Voluntary Quality Standard for Corporate Sustainability and Responsibility Research (www.csrr-qs.org).

[12] See e.g. IÖW/future-Ranking of Sustainability Reports (www.ranking-nachhaltigkeitsberichte.de).

- They are directly affected by the rating and ranking results because these can have consequences on the position of the respective company in the financial markets and in the eyes of the public.
- And finally, the econsense companies wish to extract the best possible benefits from sustainability ratings and rankings for their internal processes, i.e. by learning about their relative strengths and weaknesses.

The econsense companies are therefore interested in a transparent, efficient and valid evaluation of their ESG performance. However, there are considerable differences in the quality of the ESG ratings and rankings in the market in terms of their transparency, efficiency and validity. In fact, there is a large degree of consensus at econsense on which providers are the best in terms of quality. However, because these differences are not obvious to every "client" or reader of ratings and rankings, companies and investors alike have a justified interest in optimising the current rating and ranking practice. The following suggestions summarise the improvement potential from the point of view of econsense:

1 Further improve the transparency and comprehensibility of sustainability ratings and rankings

The improvement of transparency and comprehensibility of sustainability ratings and rankings is the focal point of the discussion. Both rated companies and investors alike must be able to understand how the company's ESG performance was evaluated. Transparency about all methodological steps forms the basis for solid quality management, enhances the credibility of results, and helps to identify improvement potential in the rated companies. If ratings and rankings are not comprehensible, the *raison d'être* of individual ratings or even of the sustainability rating model in general is put into question.

For transparent and comprehensible ratings and rankings, it is necessary to conduct a regular review of underlying assumptions and to be clear about the selection and weighting of evaluation criteria. There should be transparency regarding whether and which comparisons have been undertaken between companies, and there should be an open debate on the extent to which the indicators underlying these comparisons are actually viable to benchmark. Corporate ESG performance should also be rated with the necessary degree of accuracy. Differentiating merely between "satisfied" or "not satisfied" or a number of multiple choice options is inadequate for some topics. The evaluated companies should be given the opportunity to describe their activities appropriately in open text fields. The rating and ranking providers should also communicate whether and how such descriptions are incorporated into their analysis.

There is not a single right way of evaluating corporate sustainability. The diverse methods observed in the market merely reflect the complexity of the matter. A qualitative (versus quantitative/metric-based) evaluation is not necessarily producing lower quality results. The crucial aspect is whether the evaluation is methodologically viable, comprehensible and valid.

In addition to these criteria for the rating and ranking process, the ownership structure and the economic and personal dependencies of the providers should also satisfy the criteria for "transparency" and "comprehensibility". It is not always obvious to the rated companies which players stand behind certain rating providers, and by whom or for which purpose the results are being used. More transparency about these aspects would enable companies to concentrate their resources to provide the relevant information for each inquiry, and therefore to provide better quality to more ratings, or to the ratings most relevant for the company.

The same criteria apply to sustainability awards, which will not, however, be covered in great detail here.

2 Apply the concept of "materiality"

The work involved in participating in sustainability ratings and rankings is growing continuously. Amongst other things this is due to the fact that the providers' questions are becoming more detailed and more differentiated. A more rigorous focus on the "business relevance" of the information requested from the rated companies would reduce the amount of work involved without significantly diminishing the value of the rating. However, to guarantee the comparability of the ratings, the providers should always seek answers from all rated companies to a core set of sustainability indicators.

3 Take account of the limits of comparability of legal jurisdictions, sectors and companies

Differences between US/British and German corporate governance are the subject of regular discussions on the evaluation of corporate sustainability. The questionnaires and methods employed by rating and ranking providers do not give due consideration to these differences in some cases (e.g. workers' representatives on German Supervisory Boards). In the same way, some ratings and rankings compare companies of different sectors and draw wrong conclusions as a result. In some aspects, it would even be appropriate to differentiate between the different business models in a specific sector. It should be mentioned here, however, that some progress has been made in recent years in taking these differences into consideration: the weighting of indicators by some rating providers has been adapted to reflect the situation in selected sectors. econsense views this as a sign of a successful dialogue between the parties involved.

4 Boost the efficiency of working processes between raters, rated companies and investors/SRI-analysts

Sustainability ratings and rankings are associated with a great deal of time and expense on the part of the rated companies. Instead of being confronted with just one, companies usually have to deal with a flood of inquiries. Rating and ranking providers and companies alike should strive to use their resources as efficiently as possible. More feedback between the parties can avoid misunderstandings in the ratings and prevent the duplication of effort.

Allowing more time between annual financial and sustainability reporting on the one side, and questionnaires from rating and ranking providers on the other side, would reduce the peaks in the amount of work companies have to undertake, as well as enhance the quality of results.

However, because such a timing would in many cases not satisfy the needs of the financial markets, there should at least be a focus on optimising the efficiency of the data collection and analysis process. For instance, the providers of ratings and rankings could fill out those sections of their questionnaires in advance where the relevant data is publicly available, or concentrate their questions on those aspects not already dealt with in the sustainability reports published by the companies. This would reduce the thresholds for companies to participate in further ratings and ranking and perhaps motivate them to publish more detailed information.

5 Move towards a harmonisation of sustainability ratings and rankings

Unlike conventional credit rating, the market for sustainability ratings and rankings is characterized by a large number of providers. Moreover, the providers differentiate themselves by various means, including their methods and the principal focus of their analyses. A complete standardization of sustainability ratings and rankings is therefore not realistic in the near future. The heterogeneity of evaluation methods and the associated lack of transparency reduce the acceptance of sustainability ratings in the financial markets. Efforts should therefore be intensified to determine in which areas the harmonisation of definitions and criteria is feasible and desirable (e.g. core indicators per sector).

For some time now, standardisation processes have been taking place with respect to sustainability reporting: the reporting standard of the Global Reporting Initiative (GRI) has largely established itself around the world for the sustainability reporting by large companies. Other reporting standards (e.g. DVFA/EFFAS 3.0) can also be found in the market, although currently to a much lesser extent.[13]

From the point of view of econsense it would be desirable to align the definitions and criteria of rating and ranking providers more closely to corporate sustainability reports based on established reporting standards – although without reproducing the comprehensive portfolio of indicators included in some of these standards. Global efforts for harmonising sustainability ratings, such as the Global Initiative for Sustainability Ratings, are therefore appreciated in this context.

6 Take appropriate account of the business potential associated with ESG activities

The providers of sustainability ratings and rankings differ considerably in their understanding of sustainability (e.g. ethical/ environmental or economic approach) and take into consideration ESG-related risks and opportunities to a different extent. A look at the market for sustainability ratings reveals that opportunities in the sense of additional efficiency and sales potential associated with a strong ESG performance are often given far to little consideration. This is unfortunate because it is in the interests of both the rated companies and the financial markets to develop a realistic view on future business opportunities associated with corporate sustainability performance. The responsibility here lies in the hands of the companies who need to present convincing business cases, as well as the rating providers and investors who need to integrate this information in the appropriate way in their analyses.

7 Intensify the dialogue between raters, rated companies and investors

Rated companies are frequently seeking dialog with rating and ranking providers to gain feedback on the evaluation of their ESG performance. However, this ex-post approach can only be a first step towards improving the rating practise. Rated companies should be given the opportunity to respond to draft ratings and to prepare internal and external positions in advance of media presentations. This would boost the acceptance and quality of the results, satisfy mutual expectations, and mitigate the risk of frustration. Detailed feedback on critically rated aspects would enable companies to review and improve their ESG performance. This positive impetus to improve things in practise is frequently lost in absence of qualified feedback. A trend observable amongst some providers is to point out to the rated companies any changes in the questionnaires and/or involve them in revising the questionnaires. It would be desirable that this good practice establishes itself in the market.

8 Clearly separate sustainability ratings and rankings from other services

Some sustainability rating providers are also involved in consulting. These functions can be so intertwined that the independence and objectivity of their activities can be put

[13] Global Reporting Initiative (www.globalreporting.org); DVFA/EFFAS (www.effas-esg.com).

into question. The same applies to the tendency of some providers to charge the company as the "rating object" to take a detailed look at its rating results. This type of business relationship between raters and rated companies generates conflicts of interest and puts the neutrality of sustainability ratings and rankings – and therefore ultimately their acceptance in the financial markets and in the eyes of the public – into question.

What can econsense do to improve the quality and acceptance of sustainability ratings and rankings?

After many years of experience with sustainability ratings and rankings, the member companies of econsense are now convinced that a renewed effort needs to be made to promote constructive dialogue between the different parties. The objective of this effort is to further develop the concept of corporate sustainability and to boost its acceptance in companies, financial markets and society.

As a business network, econsense institutionalises the dialogue between companies, rating providers and investors. Under its umbrella, econsense brings together comprehensive experience by individual companies as well as sector-specific expertise which can be incorporated in the dialogue with rating and ranking providers. The understanding for the processes involved on either side can be increased by regular mutual feedback – and therefore help boost the efficiency of the rating process as well as the reliability and acceptance of rating results. As a network of German-based multinational companies, econsense can and does also contribute to overcome problems associated with the international comparability of sustainability ratings and rankings.

The providers of sustainability ratings and rankings are increasingly addressing the methodological challenges of their "products". Most of them have recognised the need to strengthen the credibility of their ratings and rankings by enhancing transparency and comprehensibility throughout the evaluation process. econsense welcomes this development, which also motivates it further to continue and intensify its dialogue-oriented approach with all parties involved. However, econsense will not engage in a "rating of the raters" itself. This task is not the responsibility of the "rating objects" but of the clients of rating and ranking providers, scientific institutions and consulting institutes. econsense is, however, eager to act as a sparring partner for such activities.