
Do we speak the same language?

A Market Survey on the Future of ESG Ratings

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About us

About 1in1000

1in1000 is a research program by 2° Investing Initiative that brings together new & existing research projects on long-termism, climate change, and (inter-)connected future risks for financial markets, the economy, and society. Its objective is to develop evidence, design tools, and build capacity to help financial institutions and supervisors to mitigate and adapt to future risks and challenges. The programme focuses on climate change (inter-) connected risks and challenges, notably risks stemming from ecosystem services and biodiversity loss, as well as risks from social cohesion and resilience. To achieve this objective, 1in1000 operates with three main areas: i) Long-term metrics; (ii) Risk (management) tools and frameworks; and (iii) Policies & incentives.

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About our funder

This research has received funding from the European Climate Foundation. Disclaimer: This work reflects 2DII's views only, and the funder is not responsible for any use that may be made of the information it contains.



About 2° Investing Initiative

The 2° Investing Initiative (2DII) is an international, non-profit think tank working to align financial markets and regulations with the Paris Agreement goals. Working globally with offices in Paris, New York, Berlin, and London, we coordinate the world's largest research projects on climate metrics in financial markets. In order to ensure our independence and the intellectual integrity of our work, we have a multi-stakeholder governance and funding structure, with representatives from a diverse array of financial institutions, regulators, policymakers, universities, and NGOs.



Introduction

ESG ratings are a ubiquitous part of the sustainable finance world.

They inform a range of investment products and decisions, from ESG-indexes to criteria in sustainable improvement loans and engagement decisions. Given their prominence, governments are increasingly exploring the need to regulate the provision of these ratings.

Despite their prominence, there seems to be significant confusion in the market as to what exactly they are designed to measure, how well they do it, and the type of regulation that should support ESG market development.

While there is a significant body of research on the correlation between ESG ratings from different service providers, there is limited analysis of market perceptions on whether ratings measure risk or sustainability, the relationship between the two, and the perception of different stakeholders. Sustainability risk refers to the risks related to sustainability themes that may impact a company's financial performance, whereas sustainability footprint or performance refers to the impact a company has on sustainability outcomes.

This note summarizes the findings of a survey of 169 sustainable finance professionals across key stakeholders: finance ESG professionals, finance non-ESG professionals, academia & research, NGOs, and the public sector.

Summary of key findings

FINDING #1: There is significant disagreement amongst stakeholders as to whether ESG ratings should represent scores focused on “sustainability risks” or “sustainability footprint”, although within stakeholders theory and practice are largely aligned. The notable exception are academics and NGOs, who see a significant gap between what the ratings should represent *in theory* and what they represent *in practice*.

FINDING #2: Survey respondents disagree with each other as to what ESG ratings should measure. The majority of respondents also think that ESG ratings currently *in practice* measure the wrong thing relative to what they should measure *in theory*. The close alignment identified in Finding #1 between theory and practice among finance sector professionals is thus primarily driven by a *systematic disagreement* that ‘neutralizes’ the results.

FINDING #3: An overwhelming majority of respondents do not think that there is a meaningful correlation between sustainability risks a company faces and their “sustainability performance” (i.e. footprint), suggesting that it is not possible to provide ratings that integrate both aspects in one score.

FINDING #4: Survey respondents strongly believe that ESG ratings should ideally be correlated across service providers.

FINDING #5: 86% of respondents think it should be mandatory that the representation of ESG scores must at the same time provide the constituent “E” & “S” & “G” score as individual parameters, with a minimum of 80% support across all stakeholders

FINDING #6: The majority of survey respondents would go even further and are in favour of abolishing aggregated ESG ratings that merge environmental, social, and governance issues, and replacing these ratings with individual “E”, “S”, “G” ratings.

FINDING #7: There currently is not market support for creating regulatory conditions under which providers can be barred from providing ratings in case of significant under performance.

Based on the findings of the survey, any ESG ratings regulation should...

Define whether these types of ratings should relate to sustainability risk or the sustainability footprint of a company.

Enforce standards around the criteria related to identifying risk or sustainability drivers.

Delineate whether a rating targets sustainability or risk objectives. This recommendation is supported by +80% of survey respondents.

Drive ESG ratings convergence through definition of standards.

Require that ESG scores must always when presented in marketing or communications materials also provide the individual E & S & G scores.

Define regulatory constraints around the extent to which aggregated ESG ratings may be provided versus ratings on individual sustainability themes, similar to the work on taxonomies.

Develop a set of standards and rules related to the right to provide ESG ratings.

Survey Results

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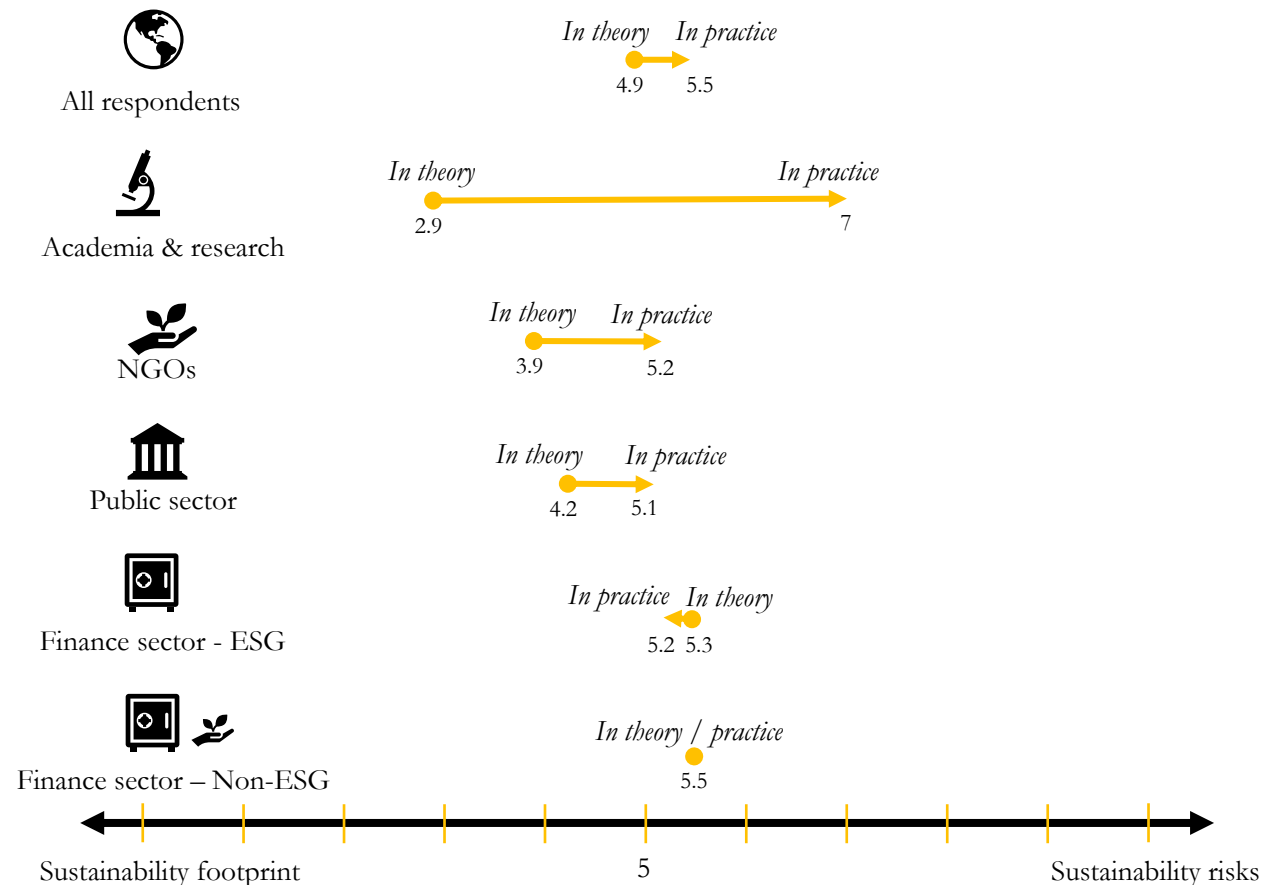
FINDING #1: There is significant disagreement amongst stakeholders as to whether ESG ratings should represent scores focused on “sustainability risks” or “sustainability footprint”, although within stakeholders theory and practice are largely aligned. The notable exception are academics and NGOs, who see a significant gap between what the ratings should represent in theory and what they represent in practice.

The survey highlights that the average perspective on ESG ratings suggests its an equal mix of sustainability footprint and sustainability risk considerations, although academic respondents, NGOs, and the public sector tilt towards footprint considerations.

The survey highlights a significant disconnect on the matter between different stakeholders. But it also highlights that the “consensus” opinion is roughly average between sustainability footprint and sustainability risks with an average score across all stakeholders exactly average between sustainability risks and sustainability footprint.

Regulatory implications: Regulation on ESG ratings should clearly define whether these types of ratings should be considered risk or sustainability ratings.

FIG 1: WHAT SHOULD ESG RATINGS MEASURE IN THEORY AND WHAT DO THEY MEASURE IN PRACTICE?

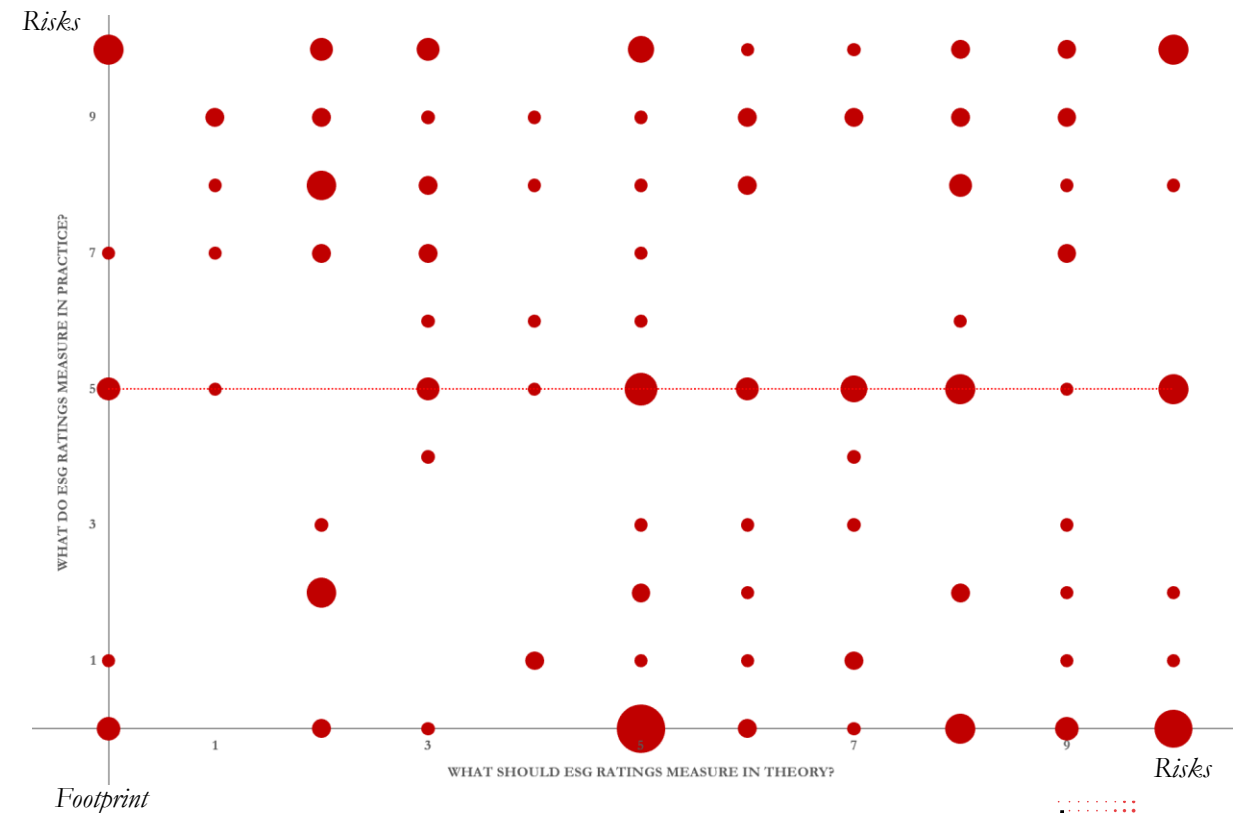


FINDING #2: Survey respondents disagree with each other as to what ESG ratings should measure. The majority of respondents also think that ESG ratings currently *in practice* measure the wrong thing relative to what they should measure *in theory*. The close alignment identified in Finding #1 between theory and practice among finance sector professionals is thus primarily driven by a *systematic disagreement* that ‘neutralizes’ the results.

Fig. 2 highlights that there is no correlation between what a respondent think ESG ratings should measure in theory and what the same respondent thinks ESG ratings measure in practice. The disagreement is striking, with some respondents saying ESG ratings *should* be a 100% risk-based but in practice is 100% sustainability footprint based, and others saying ratings should be 100% sustainability based, but in practice are 100% risk-based. We don’t speak the same language. This disagreement exists among all stakeholders. Finance sector ESG professionals thus do not have a strong alignment in Finding #1 between what ESG ratings should measure and what they measure in practice because they are satisfied, but rather because of a wide dispersion that cancels each other out.

Regulatory implications: Regulation on ESG ratings should enforce standards around the criteria related to identifying risk or sustainability drivers, depending on the choice made in regulatory implication #1.

FIG 2: THE CORRELATION BETWEEN WHAT RESPONDENTS THINK ESG RATINGS SHOULD MEASURE IN THEORY AND WHAT THEY MEASURE IN PRACTICE

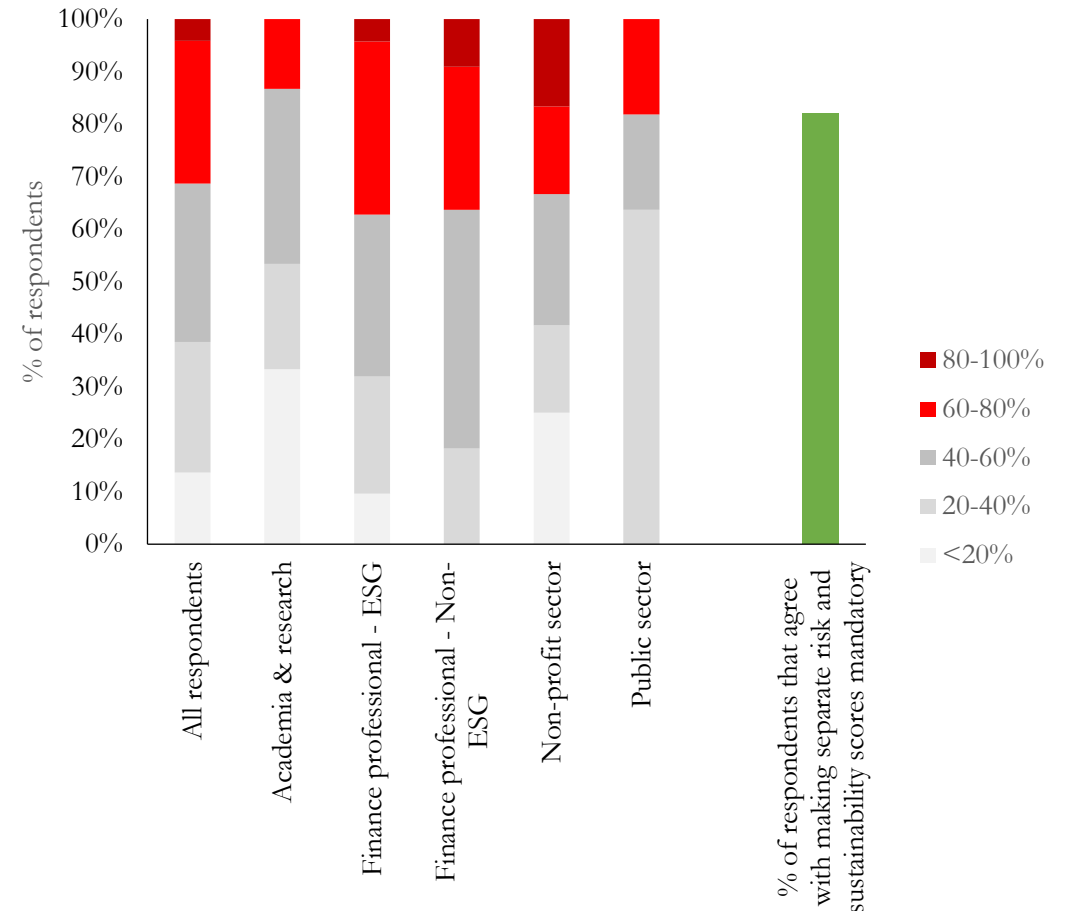


FINDING #3: An overwhelming majority of respondents do not think that there is a meaningful correlation between sustainability risks a company faces and their “sustainability performance” (i.e. footprint), suggesting that it is not possible to provide ratings that integrate both aspects in one score

Only 4% of respondents consider that the correlation between sustainability risks and performance of a company is higher than 80% and only 27% think it is between 60-80%. That leaves roughly two-thirds of respondents that consider that sustainability footprints and risk have little to no correlation. The number is lower among academics and the public sector where around 85% think sustainability risk and ratings are not correlated.

This insight is important as it suggests that ratings cannot integrate both factors in parallel. Over 80% of respondents agree that ESG ratings providers should be required to provide two discrete rating scores, with an average support score of 7.8/10

Regulatory implications: Regulation on ESG ratings should clearly delineate whether a rating targets sustainability or risk objectives. This recommendation is supported by +80% of survey respondents

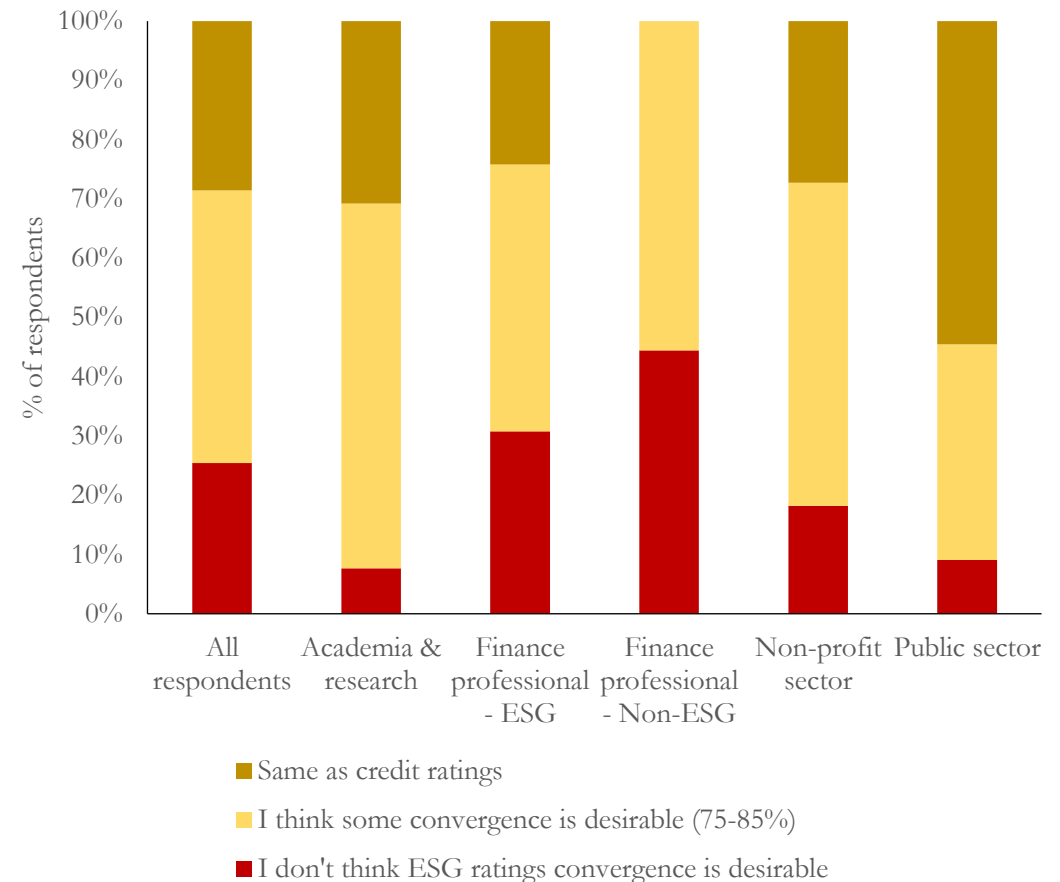


FINDING #4: Survey respondents strongly believe that ESG ratings should ideally be correlated

Respondents across all professions consider it desirable that ESG ratings should correlate either as much as credit ratings or marginally less (75-85%) across different providers.

Interestingly, this premise has the lowest overall support among non-ESG finance sector professionals and ESG finance sector professionals.

Regulatory implications: Regulation should drive ESG ratings convergence.

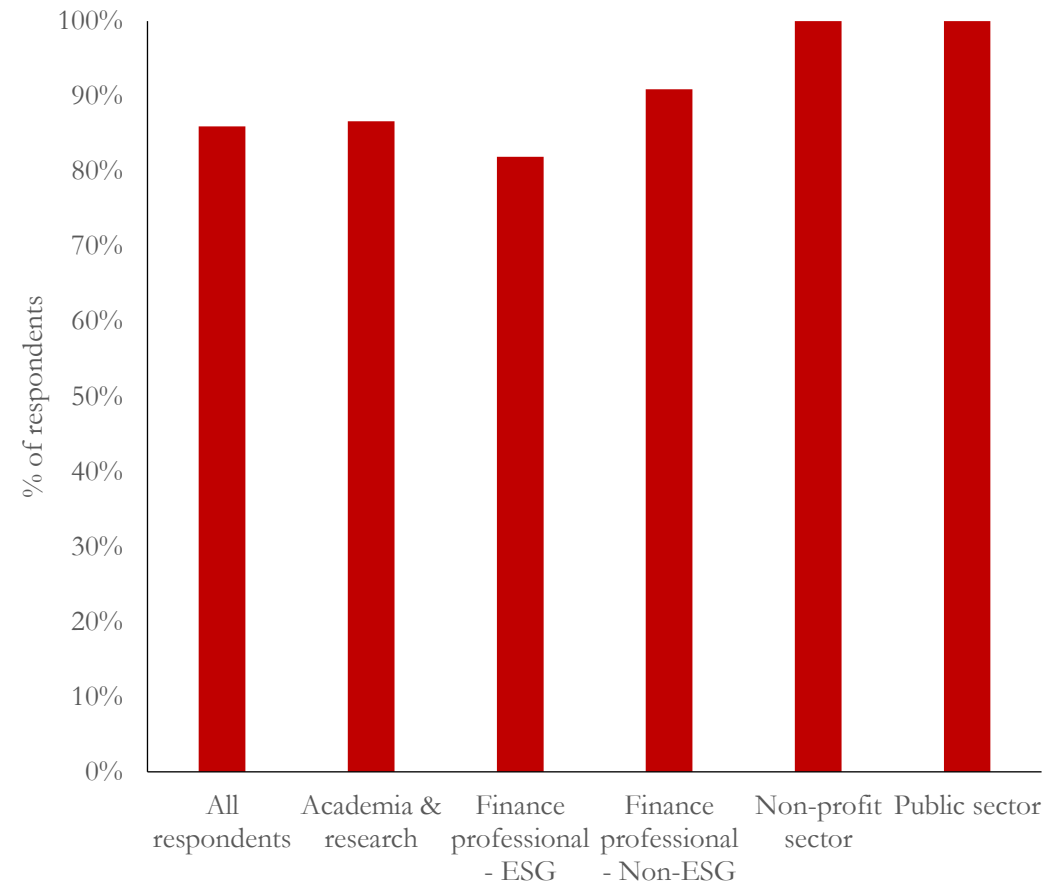


FINDING #5: 86% of respondents think it should be mandatory that the representation of ESG scores must at the same time provide the constituent “E” & “S” & “G” score as individual parameters, with a minimum of 80% support across all stakeholders

ESG ratings blend a range of different sustainability themes, as the name suggests. This can mean that an average ESG score can be a function of a high E and low S score or ‘average’ scores across the ESG themes. As a result, 90% of respondents think it should be a regulatory requirement to provide this additional information.

While we did not ask respondents for the specific rationale, the apparent reason is to avoid the obfuscation of poor performance on individual issues through aggregation of different sustainability themes

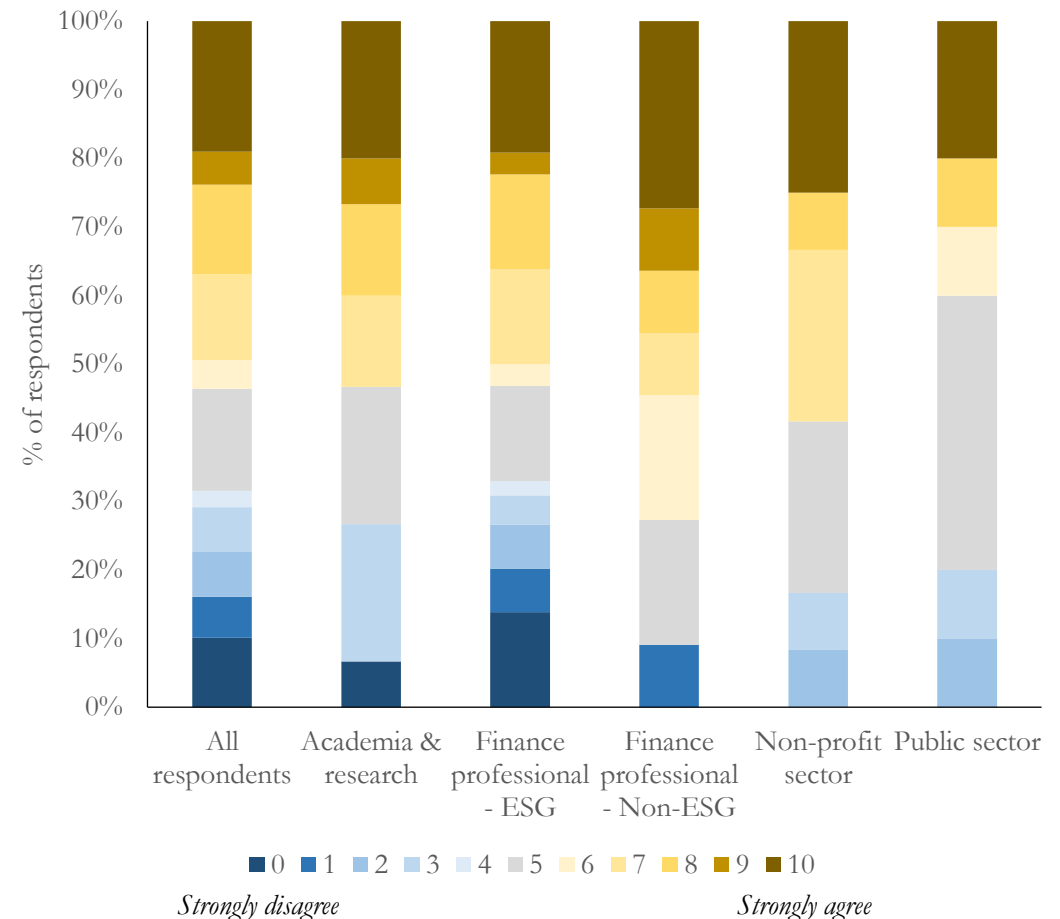
Regulatory implications: Financial regulation should require that ESG scores must always when presented in marketing or communications materials also provide the individual E & S & G scores.



FINDING #6: The majority of survey respondents would go even further and are in favour of abolishing aggregated ESG ratings that merge environmental, social, and governance issues, and replacing these ratings with individual “E”, “S”, “G” ratings.

More than half of all respondents agree that aggregated ESG ratings should be abolished altogether and ratings providers should only be allowed to publish “E”, “S” and “G” ratings. The average approval for this question was 5.7 out of 10. The results were similar across all respondents, including finance professionals working on ESG. Among non-ESG finance professionals, 70% agreed with the statement, suggesting that individuals with ultimate investment decision-making responsibility are even less in favour of maintaining ESG ratings in their current form

Regulatory implications: Define regulatory constraints around the extent to which aggregated ESG ratings may be provided versus ratings on individual sustainability themes.

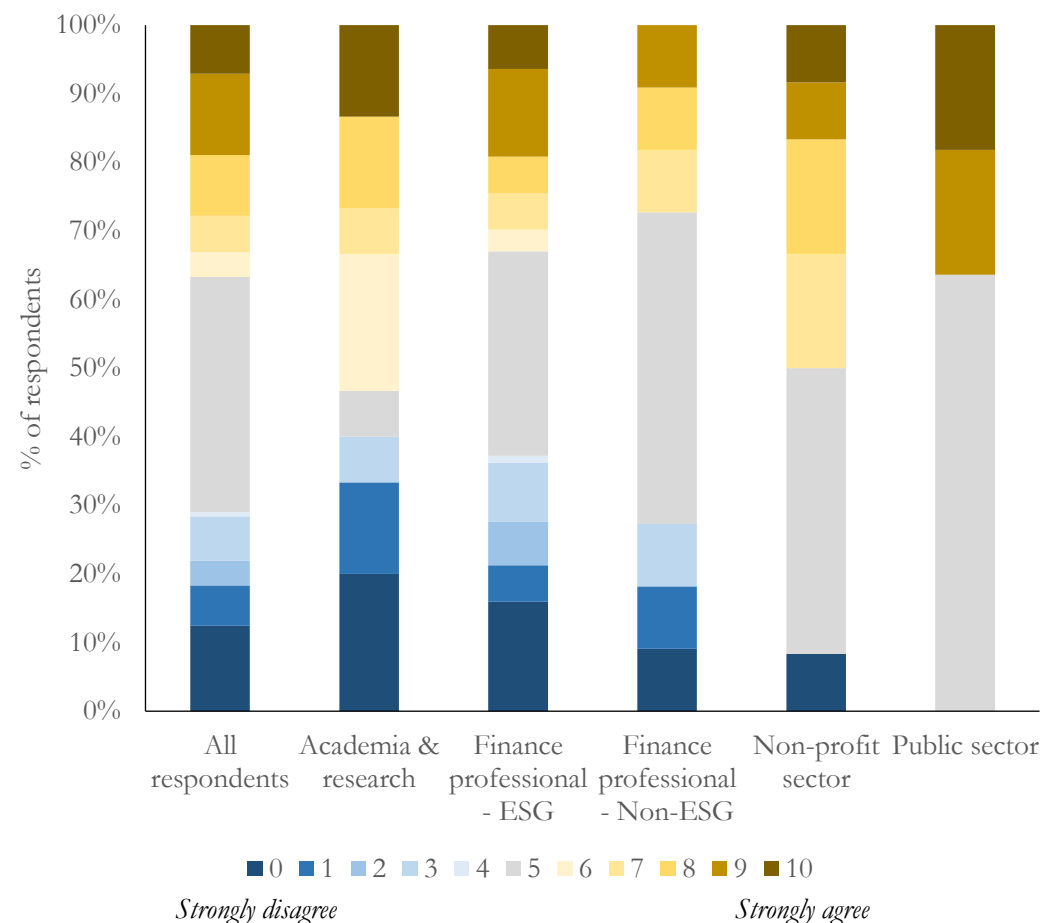


FINDING #7: There currently is limited market support for creating regulatory conditions under which providers can be barred from providing ratings in case of significant under performance.

While overall there is more support than opposition to the proposal, a significant share remain neutral on this proposal. The proposal saw particular support among academic & research respondents.

Rules around the provision of financial sector services tied to the performance of these services exist in a number of different regulatory categories (e.g. benchmark regulation, retail advice). While such rules are somewhat controversial, there is meaningful support to increase accountability of ESG ratings providers and to consider minimum rules related to the right to provide such ratings to the market.

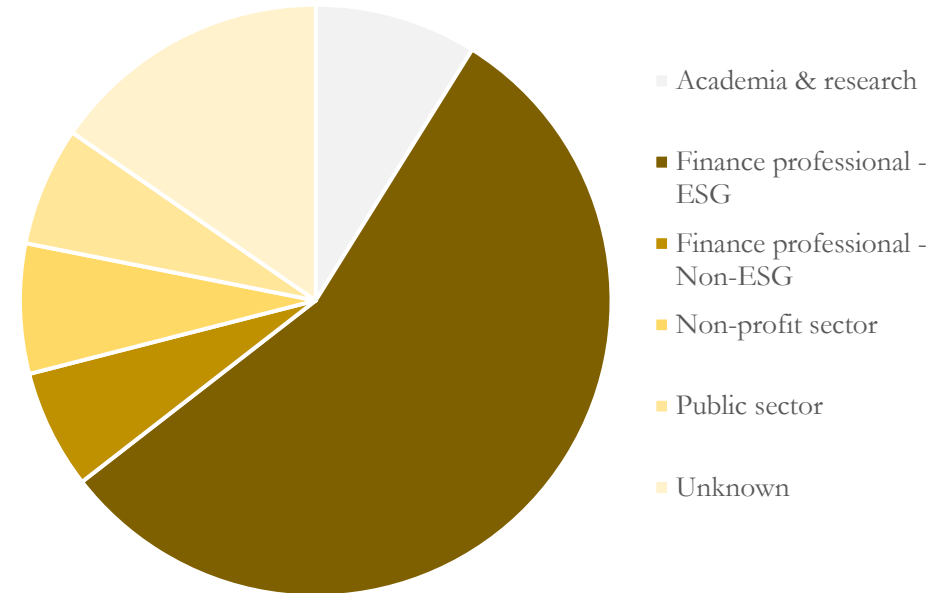
Regulatory implications: Develop a set of standards and rules related to the right to provide ESG ratings.



Annex I: Survey distribution approach

- Timestamp: 10.05.2022-18.05.2022
- # of Respondents: 169
- Distribution model: Typeform, marketed through newsletter, social media and direct email engagement, as well as media (Bloomberg, Environmental Finance)
- ~50% of respondents finance professionals working on ESG

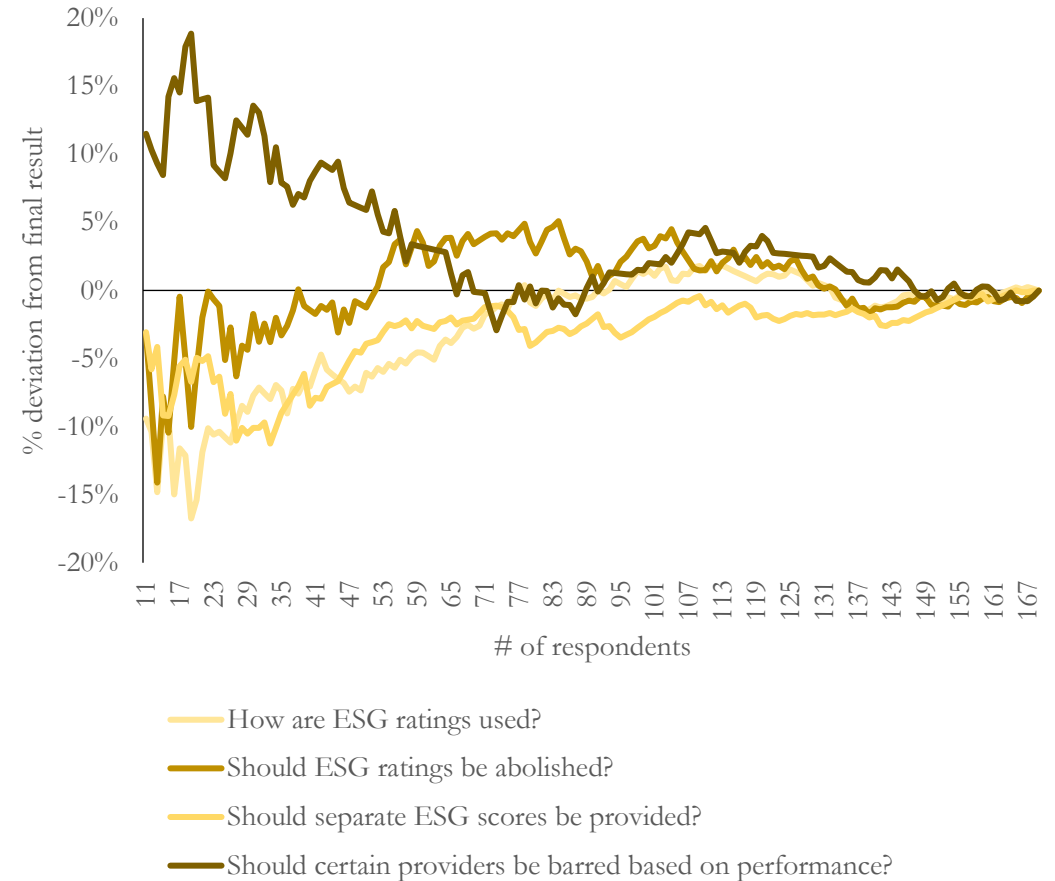
Survey respondents by profession



Annex II: A comment on statistical significance

The survey sample is anonymous and a function of the outreach actions taken by 2DII, with survey respondents primarily driven by individuals subscribed to 2DII newsletters and exposed to its social media accounts. However, the survey was also marketed through multiple industry media (Bloomberg, Environmental Finance). We feel confident that the sample is not biased.

While the overall sample size is high, the number of respondents for certain professions is limited. However, as the chart on the right demonstrates, the error bars on the results are less than $\pm 20\%$. If the 'correct' average Agree Score for a question is 5, the error may be 3.8-6.2. The results can thus be considered relatively robust overall even for individual respondent groups. Future research would benefit from a larger sample size however to increase the robustness of the results.



Annex III: Survey questions

1. What do you think ESG ratings should primarily measure in theory?
2. What do you think ESG ratings primarily measure in practice?
(1= Corporate Sustainability, 10 = Sustainability risks)
3. If you had to put a number on it, what would you say is the correlation between “sustainability performance” and “sustainability risks” of a company?
4. Credit ratings convergence is typically 85-95% according to academic research. What kind of ESG ratings convergence do you think is desirable?
5. Do you think it should be mandatory that anytime a corporate or financial sector ESG score is presented, it also contains the information on the individual “E”, “S” & “G” scores at the same time?
6. How is ESG data primarily used today? (Individual data points, mix, aggregated ratings)
7. Do you agree with the following statement: ESG ratings should be abolished and providers should only be allowed to provide individual “E”, “S”, and “G” ratings?
8. Do you agree with the following statement: ESG rating providers should be required to provide a separate ESG risk and sustainability score as two different metrics?
9. Do you agree with the following statement: ESG ratings providers should be barred from providing ratings in case of systematic underperformance of the underlying ratings as measured against a third party benchmark?
10. What is your current profession?

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