ESG SCORING SYSTEMS

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Abstract: *An ESG score is an objective measurement or evaluation of a given company, fund, or security's performance with respect to Environmental, Social, and Governance (ESG) issues. Specific evaluation criteria vary between the different rating platforms that issue ESG scores; however, they all fall within one (or more) of the E, S, or G categories. ESG rating platforms determine a weighting for each measurement criterion; then, they assess an organization's performance against each criterion. An organization's final ESG score is typically a sum-product of the criteria ratings and the (proprietary) criteria weightings.*
An ESG score is an evaluation of an organization's performance against various sustainability metrics (related to either environmental, social, or governance issues). ESG scores are generated by rating platforms where analysts evaluate corporate disclosures, conduct management interviews, and review publicly available information about an organization to provide an objective rating of the organization's performance.

Keywords: *ESG scores*

ESG stands for Environmental, Social, and Governance. The ESG score is a measure of the company's sustainability level. The calculation is based on many factors and the ESG score can vary from 0 to 100. It considers everything that the company does - from the impact on the environment to the way they treat their employees, to determine whether they meet the best practices in these areas.

An ESG score is an objective measurement or evaluation of a given company, fund, or security's performance with respect to environmental, social and governance issues (ESG). Specific evaluation criteria vary between the different rating platforms that issue ESG scores; however, they all fall within one (or more) of the E, S, or G categories. ESG scores are generated by rating platforms, where analysts provide an objective assessment of the organization's performance. An organization's final ESG score is typically a sum-product of the criteria ratings and the (proprietary) criteria weightings. ESG rating platforms determine a weighting for each measurement criterion; then they assess the organization's performance against each criterion. The final ESG score is an assessment of the organization's performance against various sustainability indicators (related to environmental, social or governance issues).

ESG scores are becoming an increasingly important factor for business as the world shifts to a sustainable economy. From now on, the company's sustainability policies will affect all stakeholders in the company, right down to the supply chain. ESG scoring systems tend to be either industry-specific or industry-agnostic. Industry-specific scoring systems assess issues that have been deemed material to the industry at large. Industry-agnostic ESG scores tend to incorporate widely accepted factors that are meaningful across industries – issues like climate change, diversity, equity, and inclusion (DEI), and human rights.

What does an ESG score mean?

A companies ESG score reflects how well it is doing in terms of environmental, social and governance best practices. It is a way for investors to see which companies are sustainable and which are not. The score is determined by considering a company's environmental impact, social responsibility, and governance practices. The result of this score is then used by investors when deciding whether to invest in a certain company's shares. In addition, as more companies begin incorporating ESGs into their business plans due to pressure from investors, some have seen improved performance as well as increased stock prices at the time of IPO (initial public offering). This has been attributed both to investor demand for sustainable investments and the fact that ESGs can lower the cost of doing business for a company, such as reducing waste and energy costs.

What do ESG scores measure?

Each ESG factor has its own set of standards that contributes to the overall ESG score. Environmental criteria measure a company's impact on the environment and their strategy to improve them. Social criteria examine a company's interactions with their social environment, such as local communities, their employees, and other stakeholders. Governance criteria examine corporate responsibility, which can include topics like business ethics and executive pay.

Environmental issues include: carbon emissions, climate change vulnerability, water sourcing, biodiversity and land use, toxic emissions and waste, packaging material and waste, electronic waste.

Social issues include: labor management, worker safety training, supply chain labor standards, product safety and quality, consumer financial protection.

Governance issues include: composition of the board in terms of diversity and independence, executive compensation, accounting practices, business ethics, tax transparency.

ESG rating companies also consider the opportunities within different ESG categories. For example, environmental opportunities can include clean technology, green building, and renewable energy while some social opportunities can be better access to communication, finance, or healthcare. All these risks and opportunities offer insights into the company that reveals a comprehensive picture of an organization's environmental footprint and green initiatives, how much the company invests in the community, and how well they will hold up against relevant laws and regulations and any legal controversies.

Who calculates the ESG scores?

ESG rating agencies are third-party companies that specialize in ESG scoring. In the US, there are over 140 firms that provide ESG scores, each with a slightly different approach with their rating system. Some of the prominent ESG score providers include Bloomberg ESG Data Services, Dow Jones Sustainability Index, MSCI ESG Research, Sustainalytics, Thomson Reuters ESG Research Data, S&P Global, ISS ESG, Vigeo/EIRIS, Fitch Ratings, and Moody's Investors Service.

How is an ESG score calculated?

Because each ESG rating firm calculates scores based on proprietary algorithms and individual criteria, no two will score a company the exact same way. In general, *ESG performance is based on data gathered from a variety of sources, including securities filings, voluntary business disclosures, governmental databases, academic* *research, and media reports*. Any ESG data that a business has made available through voluntary disclosure frameworks, such as the Global Reporting Initiative (GRI), the Value Reporting Foundation's (VRF) SASB Standards, CDP, and the UN Sustainable Development Goals (SDGs), can serve as a significant source of data for most rating providers. These metrics are divided into environmental, social, and governance scores, which are then merged into a single primary rating.

Using analysts and algorithms, the companies convert ESG metrics like a company's carbon emissions, board diversity, or safety procedures into siloed environmental, social, and governance scores, which are then merged into a single primary rating.

For example, MSCI examines hundreds of metrics and assigns a score of 0 to 10 to corporations on each important issue. These issues are weighted on their timeliness and probable impact. Issues with the greatest potential for impact (within two years) have the highest weights, whereas issues with less potential for impact and a timeline of five years or more have the lowest weights. After assigning percentage weights to ESG risks, companies are compared to their peers and given a final rating.

Companies are categorized by MSCI as leaders, average, or laggards.

ESG *leaders* are proactively managing ESG risk and taking advantage of ESG opportunities better than their peers. Leaders have AAA or AA ratings.

Average ESG performers may be managing some key issues well and others poorly, or they may be average across the board. Average ratings include A, BBB, and BB.

Laggards have relatively more unmanaged exposure to ESG risk factors and receive ratings of B and CCC.

What is a good ESG score?

Investors can compare a company's performance to that of industry peers and companies from other sectors by assigning an ESG score, which can range from 0-100. A score of less than 50 is regarded as poor, while a score of more than 70 is considered excellent.

Ratings can also be described as either excellent, good, average, or poor:

An *excellent* ESG score indicates that best practices are being followed in all ESG areas and a company has little to no internal or external problems.

A *good* ESG score signifies that a company is meeting best practices in each ESG category and has a low negative impact on people or the planet.

An *average* ESG score indicates that companies are not on track to meet ESG benchmarks or actively working toward meaningful ESG goals.

A *poor* score indicates that no best practices are being followed and are indicative of a company that is negatively impacting the environment and has employees who are being poorly treated.

Why do ESG scores matter?

Investors prefer companies with better overall ESG scores because they typically have fewer liabilities, making it easier to acquire capital and hire top talent. These companies also often have successful stakeholder relationships and a brand reputation. All these factors have an impact on the profitability and bottom line of a business. ESG scores allow investors to gauge the company's intentions actions, from how they treat their employees to how the board decisions are made or if environmental issues are being prioritized.

A high ESG score may persuade investors to engage, either because the company's values align with their own or because the company is sufficiently protected from future risks associated with issues like pollution or poor governance. An investor who is concerned about ESG may be turned off by a company with a low ESG score. Companies with a low ESG score are thought to have the worst environmental, social, and governance impacts. Undesirable ESG scores have also been linked to rising poverty levels in the communities where the firm operates, as well as poor employee mental health.

ESG score limitations

While ESG information can be useful when combined with other metrics, investors should not rely entirely on ESG scores to drive their investing decisions. The ESG score is not a reliable predictor of market success on its own, and there are numerous concerns with the existing lack of rules and transparency surrounding the criteria utilized for grading.

Recently, however, agencies worldwide have sought to address these concerns. Regulators in the US, UK, and EU recognize the need for a more uniform set of rules when it comes to ESG metrics. For example, in the US, the Securities and Exchange Commission (SEC) is working to standardize climate-related disclosures by public companies with the hope that it will aid in improving the accuracy of the ESG ratings of these companies. In the UK, the Financial Conduct Authority (FCA) has announced the formation of a group to develop a Code of Conduct for ESG ratings providers. In the EU, the European Securities and Market Authority (ESMA) is considering introducing regulatory safeguards for ESG ratings. As these agencies work towards a standardized, global agreement on ESG frameworks and ratings system, the transparency and validity of ESG scores will continue to increase.

What are the benefits of a good ESG score?

In addition to a higher stock price, a good ESG can also lead to increased benefits for employees and a healthier company. It has been seen that an increase in an ESG score correlates with increases in innovation, productivity, and profitability. This is because companies with a good ESG score have more engaged employees who are willing to take more risks and innovate. In addition to this, there are benefits for the environment as well. As companies improve their ESGs, they will be able to reduce their resource consumption and waste levels which will result in a healthier planet.

What are the effects of a poor ESG score?

Companies that have a poor ESG score are seen as some of the worst companies for the environment, society, and governance. For example, some companies with bad ESG scores pollute local waterways leading to issues such as higher numbers of people suffering from cancer, due to the chemicals from these companies getting into drinking water. In addition to this, poor ESGs lead to increased poverty levels in areas where these companies are located, while also leading to decreased employee morale and motivation.

Who uses ESG ratings?

ESG ratings are used by *investors* when looking at potential investments to determine whether they will be able to get a good return on their investment. However, if the company has an extremely low ESG score (below 50), this is seen as creating too much risk for the investor and can lead to them choosing not to invest in that company. This is because of all the problems associated with poor ESGs.

ESG ratings are also used by *companies* themselves to determine which areas they should improve to have a better score overall. This is because the company will see higher profits if it invests in departments with low ESG scores, while reducing any risks associated with poor ESGs. This could mean that the company would come up with new recycling programs or spend more time and money on improving their environmental impact.

ESG ratings can also be used by *governments*, with some countries requiring companies to have an average of at least 50 before they're allowed to operate within that country due to the number of issues associated with poor ESGs.

What factors comprise an ESG score meaning?

Factors considered depend on the methodology used, but most companies look at things like carbon emissions, energy consumption and waste production as it relates to company operations. They also consider supplier assessments, employee diversity/discrimination, supplier diversity, pay ratios and executive compensation.

What are ESG risks?

There are some companies that prefer not to disclose their scores publicly, or at all. It is because they believe that ESGs can change too quickly for them to keep track of it on an annual basis. There is also some concern that the more information you disclose, the easier it becomes for your competition to catch up with you in terms of ESGs, which could end up hurting you in the long run.

How does this affect the share price?

ESG scores have been known to impact share prices, however not always directly. It depends on how much of a difference there is between the current score and the score the investors would like to see. It has also been known for companies whose ESG scores are below the average (50) to see their share prices increase with time as they improve in that department, while those who are above the average tend to see their share price decrease over time.

Which industries are most affected by ESG scores?

Some companies have stated that they are willing to pay a premium for them because environmental, social and governance factors are becoming increasingly important to large investors. High scoring industries include technology and healthcare. Low scoring industries include finance and oil and gas.

There are six elements that are used to calculate an ESG score

An ESG score generally involves several different factors, including:

• Revealing the organization's environmental footprint (through their use of energy and raw materials) and any positive initiatives they might have to reduce or offset this. It will include other factors like how much waste they produce and recycling initiatives.

• Calculating how much the company is spending on things such as social welfare and charitable donations. These elements matter because they are a sign that the company is willing to be generous and invest in communities. Examining how much of priority internal promotions are for an organization. This factor might seem unrelated, but it's important because organizations who prioritize diversity tend to have more positive relationships with their employees and therefore receive better scores.

• Asking the company to disclose information on their employees, including working hours, living wages and any gender disparities. This also includes the Board of Directors. Governance factors are important because it shows that an organization is investing in diversity on a leadership level.

• Comparing the company's environmental policy to relevant laws and regulations, including global guidelines like the OECD Guidelines for Multinational Enterprises. The aim of this factor is to encourage companies to follow best practices even if they're not legally obliged to do so.

• Comparing their policies on bribery and corruption against relevant laws and regulations. It also includes whether they have been involved in any controversies related to these types of activities.

• Undertaking a review of how transparent the organization is, including what information they disclose on their website and social media. This factor helps instill trust between companies and investors by increasing transparency.

How have ESG scores been used historically?

The first ESG scorecard was created in 1999 by Innovest, a research firm. In 2012, Bloomberg published an index of the 100 most sustainable companies worldwide based on their ESG score. The index has since been discontinued but there are many other examples of how ESGs have been used to evaluate businesses through different types of comparisons. The markets have also expanded to include personal ESG scoring, which measures an individual's sustainable practices.

What is the future of ESG?

With an increase in Billion-dollar weather events our effects on the climate can no longer be ignored. ESGs are now increasingly popular with investors who are looking for sustainable investments. Prior to the pandemic, a 2017 study found that 63% of respondents had increased their investments in companies with high ESG ratings, and 44% were willing to pay a premium for this type of investment. It's likely that the prevalence of sustainable investing will continue to increase.

What do ESG scores mean for business?

Because companies that have a higher overall score receive more interest from investors, it means that they are going to have the ability to raise capital easier and at a lower cost of capital than their less-sustainable counterparts. It also means that they are going to be able to hire people with a lower risk of litigation when it comes to environmental, social and governance issues. Other effects might be a positive relationship with stakeholders, a more favorable company image and a lower likelihood of government intervention. All these factors can have a positive effect on a company's business performance.

What is the cost of increasing an ESG score?

The costs associated with increasing an ESG score are numerous, but they are also necessary to ensure that the best practices are being followed. For example, if there is a lack of diversity in the workplace, employees may feel left out or uncomfortable. This can lead to low morale which can then trickle into productivity and profitability. Companies need to consider how their choices affect the people who work for them. They also need to consider the environment and whether their current practices are harming it in any way. We often hear about companies who are spending 10's of millions through litigation, penalties, and court proceedings. What if they just did the right thing in the first place? Is litigation a sustainable business model?

What do ESG scores mean for investors?

In the recent past this answer would be considerably different than it is today. But typically, the returns from sustainable businesses have consistently outperformed the competition. And now with the rapid divestment from everything Soviet and the near collapse of the world supply chain, we are going to see some major upside from proving your sustainability.

Are there any limitations to ESG scores?

There are a few things worth noting when using ESG scores as an investor. The first is that they don't take into account the long term. A company may have a low score for social practices, but it could be because they are in a growing phase and will improve over time. Another issue with ESG scores is that they can change drastically from year to year or month to month, depending on what is driving the markets at any given moment. But remember that you compare apples to apples and oranges to oranges. That is to say that an ESG score is industry specific and geographically related. Comparing a mining company against an electronics retail chain is not going to give you accurate data.

There are four different types of ESG scores

1. **Environmental -** this type of score looks at a company's emissions, water usage, waste management, and other environmental factors.
2. **Social -** this type of score looks at a company's employee relations, customer satisfaction, human rights record, and other social factors.
3. **Governance -** this type of score looks at a company's board diversity, transparency, shareholder rights, and other governance factors.
4. **Financial -** this type of score looks at a company's financial stability, profitability, and debt management.

Each type of ESG result is important in its own way and together they give you a complete picture of the company's sustainability. But since the first ESG reports were collected, a lot has changed in the way companies operate. And many things have changed in the way we collect and quantify these data.

What is a "good" ESG score?

A good ESG score is one that meets best practices in each category. For example, an environmental score will consider energy consumption, usage of chemicals and waste management. A good ESG score would be one that has a low impact on the environment.

What is a "bad" ESG score?

A bad ESG score is one where the best practices are not being followed in an area. For example, a social scorecard would consider diversity in the workplace and employees that feel accepted and appreciated. A bad ESG score would be one where employees do not feel comfortable or have been treated poorly.

What is an "average" ESG score?

An average ESG score is what many companies produce because they aren't purposefully reducing their environmental impact and aren't really thinking about the people who work for them. These scores are acceptable, but not ideal.

What is an "excellent" ESG score?

An excellent ESG score would be one where the best practices are being followed in all areas of the scorecard. For example, a governance score would look at internal and external factors. An excellent score would be one where the company has little to no problems internally or externally.

What is a 'horrific' ESG Score?

A horrific score would be one where the best practices are not being followed in all areas of the scorecard, especially an environmental or social one. For example, an environmental score would look at energy consumption, usage of chemicals and waste management. A horrific score would be one where the company had a high negative impact on the environment or are causing major issues with their employees internally or externally.

How do ESG scores work?

Increasingly, management teams at public companies are being required (by stock markets and government bodies) to provide ESG disclosure with their quarterly and annual reporting. In order to report clear and relevant metrics in a standardized format, they will select a reporting framework.

Some common frameworks are the Global Reporting Initiative (GRI), the Principles for Responsible Investment (PRI), and the Sustainability Accounting Standards Board (SASB). When company management teams disclose ESG information without the use of an appropriate framework, it's often referred to as Greenwashing.

Stakeholders and rating agencies interested in producing ESG scores will review these company or fund disclosures, then conduct management interviews, compare results and metrics to other companies in the industry, and present an ESG score for the company.

ESG raters help bridge the gap between an organization's disclosures and the general public's interpretation of the organization's ESG behaviors and performance. Scores are also used by the financial analyst community to help inform capital allocation decisions.

Who measures performance and assigns an ESG score?

These scoring systems can be from finance and investment firms, consulting groups, standard-setting bodies, NGOs, and even government agencies. Broadly speaking, however, there are two major categories of raters that generate ESG scores – these are external and internal stakeholders.

1. External Stakeholders/Rating Platforms

External stakeholders consume company disclosures, review publicly available information, and conduct primary research with company management about the organization's sustainability efforts. Examples include:

• **ISS** (or Institutional Shareholder Services) is one of the largest institutional investor advisory services in the world; they have a variety of scoring systems, including issue-specific scores (like its "Carbon Risk Rating" or its "Water Risk

Rating") and category-specific measures (like its "Governance Score"), as well as an overall "Corporate Rating."

• **CDP** (the Carbon Disclosure Project) is a non-governmental organization that publishes ESG ratings, particularly around environmental factors. CDP is known for its level of rigor in conducting primary research directly with issuers, as opposed to relying on an organization's voluntary disclosures.

• **MSCI**, Sustainalytics, and S&P TruCost are examples of financial services entities that measure and present ESG ratings for public consumption.

2. Internal Stakeholders

Internal ESG scores, in the form of ESG scorecards, are also used to gauge performance within an organization. In fact, more and more entities are creating in-house scoring systems to monitor and report on their own performance. The purposes of internal ratings include, but are not limited to:

• Comparing performance across business units or geographic markets.

• Measuring actual results against specific issues affecting company stakeholders (like customers, suppliers, or employees).

• Conducting horizontal analysis to measure changes in performance, period-over-period.

What does an ESG score mean?

• High ESG scores are a constantly moving target as the scores are frequently impacted by the performance of other industry players, macro industry trends, and alterations to the scoring platform's internal methodologies.

• Scores are also hard to assess in "absolute" terms. However, all other things being equal, an organization that consistently achieves high ESG scores across a variety of rating platforms is likely to perform well relative to its peers.

• Leveraging insight from a given ESG score in a meaningful way can only be achieved by understanding the broader context of the situation, as well as knowing what inputs are being measured (and what kind of weightings are being used) to arrive at a particular score.

How are ESG scores used in the market?

• ESG scoring systems are created for different use cases and for different stakeholders (based on their associated needs); some are designed to support capital allocation decisions (like investments or assessing credit risk), while others may support human capital management and staffing decisions.

• For example, CDP (The Carbon Disclosure Project) is an NGO scoring system for corporate performance on a variety of environmental issues like carbon emissions, climate change, water, and forestry. CDP is popular within the investment community, as asset managers can use positive or negative screening to identify top (or bottom) performers with respect to environmental issues.

• Just Capital is a consumer-focused NGO scoring system that assesses corporate performance on stakeholder issues – such as how a company creates value for its employees, suppliers, and local communities. Just Capital may be leveraged by consumers or prospective employees when searching for a company to buy from (or to work for).

• In virtually all cases, these methodologies are being updated regularly, making one's understanding of evolving ESG factors important when trying to interpret or get actionable insight from a given score.

Conclusion

An ESG score is a rating that's used to determine how sustainable a company is in the areas of environmental impact, social impact, and governance. The result of this score is then used by investors when deciding whether to invest in a certain company's shares. In addition, as more companies begin incorporating ESGs into their business plans due to pressure from investors or governments, they will have a higher stock price which will increase profits for the investor. This has been seen in companies that have already begun to make the switch to incorporating ESGs into their strategies. Finally, by improving departments with low ESGs, organizations can see increased morale and motivation along with better performance overall.

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