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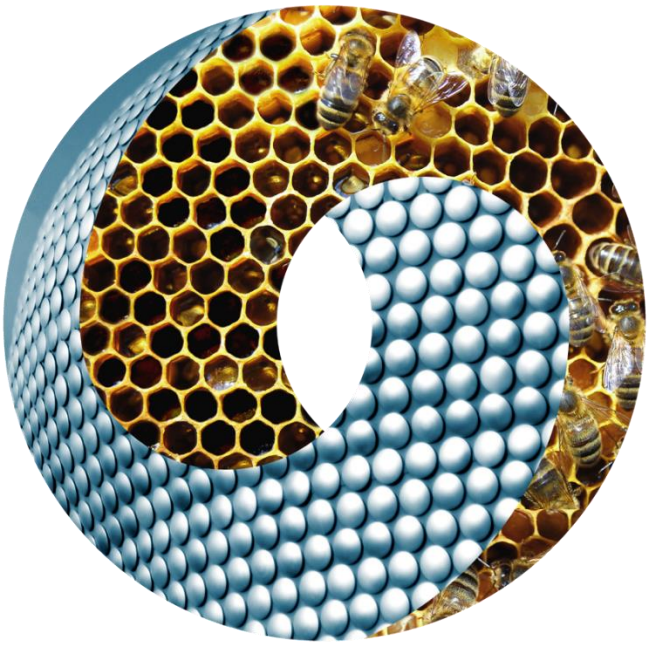
LECTURE N°6
2023 Series



Deloitte Climate & Sustainability Competency Lab

From science to business: providing companies with the knowledge to turn sustainability into action.

LECTURE N°6 | ESG ratings & sustainable finance

Interview with **Florian Berg**

Florian Berg is a research scientist at the MIT Sloan School of Management where he cofounded the Aggregate Confusion Project. His research interest covers sustainable investing with a focus on ESG ratings, the disagreement between different rating agencies, and how it affects investors, firms, as well as academic research. Florian received his PhD in economics from Paris-Dauphine University. During his PhD, he held a visiting research position at ETH Zurich. He worked as a quantitative researcher at Amundi Asset Management and as a quantitative strategist/trader at Alphadyne Asset Management. Berg taught at Paris-Dauphine University, Sciences-Po Paris, and MIT Sloan.

Q.1

What is an ESG rating and how is it computed?

ESG ratings are an opinion about the environmental, social and governance performance of a firm. There are two different philosophies that these ESG follow: either **financial materiality** or **double materiality**.

Financial materiality is about the **risks and opportunities** that ESG factors present; double materiality adds a layer of what companies' operations have as an **impact** on the outside world.

All the different ESG ratings rely on a variety of issues and topics that can be between 35 and 286, which are all interestingly aggregated and computed in the same way, that is via linear weighted average between those indicators. This in turn presents a whole different set of potential problems, the most relevant being the disagreement among providers.

C-TAKEAWAYS

Fast facts for the C-level

- ESG ratings differ quite a lot
- ESG divergence doesn't make the signal less valuable
- ESG ratings strongly contribute to data accessibility and reducing the moral distance from investments
- ESG ratings and measurement will only rise in importance
- Make the best out of ESG ratings so to benefit from the advantages of the potential lower cost of capital
- Create a direct information flow with the ESG department to know what's going on in your company
- Know your disclosure and then work on having a better rating
- Even if you disagree with ESG ratings, remember that they are very important within the market
- Use ESG ratings to create a positive impact on society

Q.2

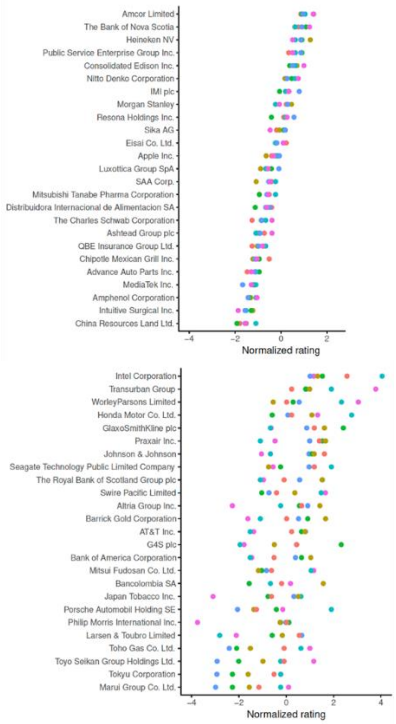
Why are ESG ratings different and why is that a problem?

ESG ratings' divergence in opinion is not necessarily a problem per se, but when you zoom in, there are two reasons why this happens. *(See graph on the right)*

One is the **definition of sustainability**: how do I define sustainability? Do I follow financial or double materiality? Which issues are important: is climate change risk important? Is corruption important? Is electromagnetic field pollution important? Then, once you settle on your opinion, you need to think about how relatively important these topics are to each other.

The other reason why there's divergence is **measurement**, which is more problematic because if we want to measure the same topic coming from the same materiality philosophy, and we disagree, we come to different outcomes, which hints that we both, or at least one of us, do not know how to measure it perfectly. These are high topics to assess: for instance, when we look at discrimination, we really want to figure out what the true discrimination performance of a company is. To get the data, we need proxy data to assess it, such as the gender pay gap or how many women or historically disadvantaged groups are on the board or get promoted.

This doesn't mean the signal has no value. Just because we measure something noisy, it doesn't mean that we shouldn't measure it. In fact, it might still be very informative.



Source: Florian Berg, 2023. The divergence of ESG Ratings. The upper graph represents the "Highest Agreement", while the lower one, the "Highest Disagreement". These two charts highlight that the disagreement is not higher for different industries or different market capitalizations. However, for many enterprises there is substantial disagreement among providers.

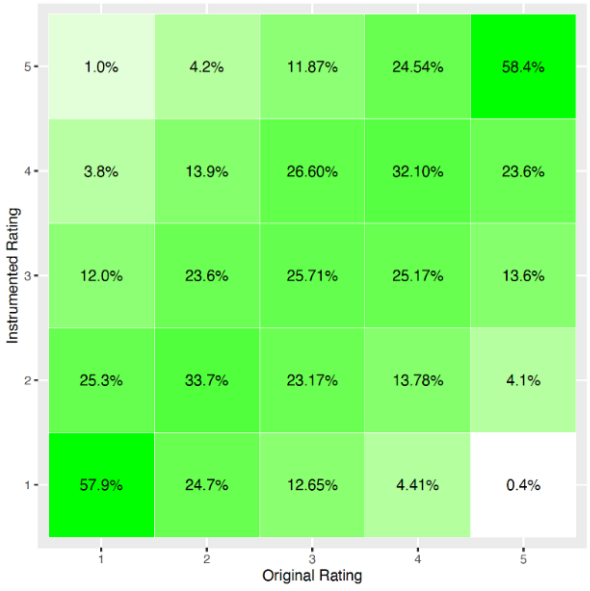
Q.3

What could be the solutions?

For the definition of sustainability, I think we have to agree that there are different points of view on what is actually what. How would you define sustainability? Even within my own Aggregate Confusion team, when we look at our preferences, they're completely different, but there's nothing to be scared of.

For the measurement issue, there are basically two ways of dealing with it. The first is a **short-term statistical solution** (see graph below): we buy data and use some statistical algorithms to leverage the signal in different ESG ratings. The second is a **long-term** one: we set regulatory **incentives** so that those ESG raters compete on better methods and measurements. The two variables are **transparency and accountability**. Accountability in the sense that companies need to have a mechanism that makes ESG raters discuss with companies if they're not happy with their scores.

This means that ESG raters still have the last word but at least companies must be able to reach out, generating a lot of interaction and learning effects for ESG raters as well.



Source: Berg, Florian, Kölbel, Julian, Rigobon, Roberto and Pavlova, Anna. ESG Confusion and Stock Returns: Tackling the Problem of Noise (2022) The top right number is the number of companies that remain in a portfolio after the correction for noise happens. 41.6% change: 0.4% of these companies become the worst rated companies in the whole sample. 13.6% that were previously the best, are now in the middle. Massive change occurs following this statistical method and the sustainable portfolio will look much different: 41.6% of stocks will leave and be replaced by others.

Q.4

How can ESG ratings be used to make a positive impact on society?

Several ways, most notably in **sustainable investing**. We need ESG ratings to figure out which companies are sustainable and which ones are not. I think ESG ratings **are a revolution in terms of data accessibility**, in the sense that big companies can have the right to get due diligence of a company if engaged in a merger and acquisition, but smaller investors don't necessarily get that information. And I think this is what ESG is about: it provides everyone with this kind of data.

ESG ratings might also align investments with values by **reducing the moral distance from investing**. Because people have morals and they rarely pursue financial objectives only, I think everyone is very likely to integrate them into their investments. For example, if you have an investment that gives you 10% and another 10.1%, very few would choose the 10.1% if they knew that it involved children working under the exposure to mercury. ESG ratings try to bring to light this kind of information instead of keeping it hidden. It is also very useful if we can tell investors which companies to shy away from.

As an investor, you can also use ESG ratings to engage in **shareholder activism**. For example, an activist investor could target companies that have low ESG ratings by buying a stake to engage with them to improve the operations as well as ratings. This, in turn, might make the investor benefit from the potentially higher stock price.

There are several ways of having a positive impact on society, but mostly through portfolio allocation.

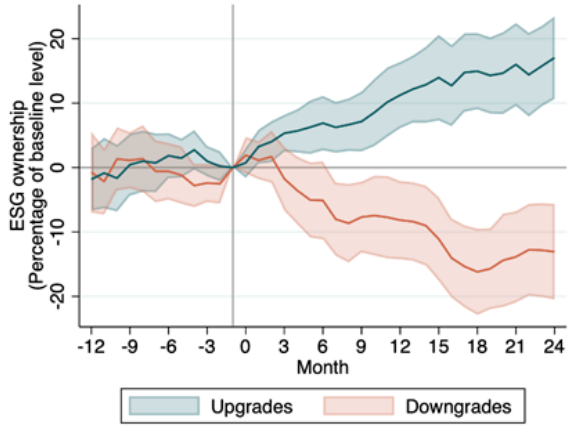
"I think ESG ratings are a revolution in terms of data accessibility… they also create a positive impact on society by reducing the moral distance from the investing."

Q.5

Why is it important that this topic enters the corporate narrative and what benefits can companies get out of it?

I think ESG ratings and ESG measurements are here to stay, and they **will be even more important in the future**. In our research, we show that they already influence the buying and selling decisions of investors and have an overall impact on the market cap.

Therefore, companies need to know how to optimally report for those ESG ratings because they also want their ESG efforts to be acknowledged in order to benefit from the advantages of the lower cost of capital that potentially comes with it (see graph below).



Source: Berg, Florian, Heeb, Florian, and Koelbel, Julian. The Economic Impact of ESG Ratings (2023). This graph shows that ESG funds react to MSCI's ESG rating changes and by that have an influence on the cost of capital of firms.

Q.6

What advice would you give to the C-level?

I think C-levels should not only optimize their ESG ratings and delegate them to a different department, rather they should create a direct information flow from the department that creates the ESG disclosure to the C-level: this would allow the latter to know what's going on in the company when it comes to ESG reporting.

Nowadays, I think the big problem is that there are still many companies **delegating ESG reporting to one specific department**. In many cases, this prevents them from knowing their ESG rating and from potentially optimizing, improving, or changing the general practices, having a better sustainability performance, and being recognized for that.

My advice for the C-level is to **really know your disclosure** and ESG performance, and then **work on having a better rating**. Even if you disagree with ESG in general, the market still thinks it matters. ESG disclosure and rating are part of your sustainability efforts. You have to know what you disclose and how.

"My advice for the C-level is to really know your disclosure and then work on having a better rating. Even if you disagree with ESG in general, the market still thinks it matters."

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