



Sustainability indexes

Presentation FEB Academy (Ghent University)

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Presentation based upon

- Bouten, L., Michelon, G., Roberts, R., (forthcoming) The Challenge of Measuring CSR Performance, in: Magnan, M. and Michelon, G., Handbook on Corporate Governance and Corporate Social Responsibility, Edward Elgar Publishing.
- Bouten, L., Cho, C., Michelon, G., Roberts, R., When ratings become 'make your own' menus: Prosumption and mediated reactivity in environmental, social, and governance (ESG) ratings (WP)



Stock market indexes



MSCI



2019 Constituent
MSCI ESG
Leaders Indexes

MORNINGSTAR Indexes



SUSTAINALYTICS

a Morningstar company



Dow Jones
Sustainability Indexes

**EURONEXT®
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ESG LARGE
80 INDEX**

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But more than an index



FTSE4Good indexes can be used in four main ways:

- **Financial products** - as tools in the creation of index-tracking investments, financial instruments or fund products focused on sustainable investment.
- **Research** - to identify companies with specific environmental and social practices.
- **Reference** - as a transparent and evolving global **ESG standard** against which companies can assess their progress and achievement.
- **Benchmarking** - as a benchmark index to track the performance of sustainable investment portfolios.

Phenomenon called
REACTIVITY
(Espeland & Sauder)



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What is reactivity?

- The concept of reactivity refers to the idea that organizations “change their behavior in reaction to being evaluated, observed, or measured” (Espeland & Sauder 2007, 1).
 - **Reactive conformance:** change their behavior **in line** with the criteria they are evaluated against, in line with the ratings
 - **Strategic conformance**
 - gaming the ratings (by providing incomplete, even deceptive, and/or inaccurate information)
 - lobbying for changes with the raters, or attempting to adjust the scoring system (engaging with raters to shape their criteria, weights or data sources) (Espeland & Sauder 2007; Sauder & Espeland 2009; Pollock et al. 2018; Sharkey & Bromley 2015).



What is reactivity?

- Ratings as **engines of anxiety** (Espeland & Sauder, 2016)
 - Studied Law School Ranking of U.S. News and World Report (USN)
 - The idea of dropping in the ranking makes law schools anxious as they think they will be able to attract less good quality students and professors, and their students may have face problems to find high level jobs, creating further deterioration in the rankings
 - **Context specific elements:**
 - 1 dominant ranking
 - Students taking the rankings at face value



Reactivity & ESG indexes/ ratings

- Sustainability/ESG indexes are based upon a **rating or ranking** and it is those who can set some norms

**BROAD EXPOSURE TO
SOCIALLY RESPONSIBLE
US COMPANIES**



MSCI KLD 400 Social Index

Launched in May 1990, the MSCI KLD 400 Social Index is the first Socially Responsible Investing (SRI) index¹. With the growing mainstream adoption of ESG strategies, many investors seek to hold companies that reflect their values and meet stringent best-in-class criteria for managing their environmental, social and governance (ESG) risks and opportunities.

Reactivity & ESG indexes/ ratings

- Sustainability/ESG indexes are based upon a **rating or ranking** and it is those who can set some norms
- HOW would reactivity work here:
 - Investors using these ratings (directly or indirectly) to identify companies worthy of inclusion (or not) in their SRI or mainstream funds, create anxiety within firms
 - Consequently, these ratings become instrumental in disciplining companies' behavior and decisions and may be regarded as some soft law devices (Malsch 2013; Slager et al. 2021).
- **BUT**
 - **Not 1 dominant ESG rating**
 - **Investor using ratings at face value?**



Unravelling reactivity in the context of ESG ratings



- Understanding the ESG ratings field
 - Most used flagship ratings
 - History
- How do investors use the ratings?
- How do companies respond to the ratings?



Most used flagship ratings by AM/AO analysts



Most used flagship ratings by AM/AO analysts

How MSCI ESG Ratings work

We use a rules-based methodology to identify industry leaders and laggards. We rate companies on a 'AAA to CCC' scale according to their exposure to ESG risks and how well they manage those risks relative to peers. We also rate countries and mutual funds and ETFs.

MSCI ESG Ratings provide insights into potentially significant ESG Risks so you can make better investment decisions and communicate with your clients. Download the [MSCI ESG Ratings brochure](#).



MSCI
ESG RATINGS



CCC B BB BBB A AA AAA



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a Morningstar company



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Most used flagship ratings by AM/AO analysts



Barco NV

Industry Group: Technology Hardware

Country/Region: Belgium

Identifier: BRU:BAR

Barco NV is an electronic components company with three business segments: Entertainment, Enterprise, and Healthcare. The Entertainment business segment provides lighting, projection, and LED services for cinema, retail, and hospitality businesses. The Enterprise segment provides businesses with visualization solutions and software f...

[+ Show More](#)

Full time employees: 3,191

ESG Risk Rating CORE ?

13.0 Low Risk



Last Full Update: Oct 24, 2022 ?

Last Update: Nov 22, 2022 ?

Ranking

Industry Group (1st = lowest risk)

Technology Hardware 111 out of 655

Universe

Global Universe 839 out of 15617



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Most used flagship ratings by AM/AO analysts



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Insights & Analysis

Solutions ▼

Our Comprehensive Offering

With Moody's, you can access clearly-labelled data – aligned to globally recognized standards and regulatory taxonomies – that brings credibility to your analyses, product innovation and reporting.

ESG Scores & Assessments

Powered by a double materiality lens, ESG scores and assessments on entities ranging from large-cap companies to SMEs, and sovereigns and sub-sovereigns. Verified and modeled scores, as well as analyst-led assessments are available.

Positive & Negative Screening

Negative and positive screening data to inform asset stewardship, portfolio management and construction of labelled funds or indices.

[Learn more »](#)

Portfolio Review Services

Reporting tools for documenting a portfolio's ESG performance. Fully customizable reports to suit individual needs.

ESG Controversy Monitoring & Alerts

Aggregated assessments of a company's exposure to and management of ESG controversies. Accessible via daily alerts or a dashboard view displaying historical exposures and responses.



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a Morningstar company



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BUT

... what do these ratings measure?

... what do they consider as “good”/ “bad” sustainability/CSR/ESG behavior?

....let’s go back to the “roots”



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KLD Research & Analytics, Inc.

- Kinder, Lydenberg and Domini was founded in Boston in 1988 with the purpose to “***influence corporate behavior toward a more just and sustainable world.***”
- Advocacy attitude – **values-based methodology (Eccles et al., 2020)**
 - KLD’s rating framework considered a wide range of stakeholders and defined a full list of controversial issues (nuclear energy, weapons sale, pollution, etc.).
 - KLD focused its ESG assessment specifically on the benefit or harm to the wider society and not on the financial benefit for investors.
 - Strengths and weaknesses regarding the environment (including climate change and operations management), the community, corporate governance, diversity, employee relations, human rights, and product quality and safety



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Innovest Strategic Value Advisors, Inc.

- Founded in 1992 by Dr. Matthew Kiernan, who wanted to create the *green Moody's*
- In 2004, Innovest launched a new flagship product, the Intangible Value Assessment (IVA).
- Innovest sought to move beyond the negative screens and values-focused assessments, embracing instead the goal of demonstrating the financial superiority of high CSR performers

=> Value-based methodology

- **“Intangible value”**
 - Defined as driven by 50 performance indicators that could be allocated to four main clusters of nonfinancial assets that were considered to be financial-drivers:
 - EcoValue or natural capital
 - human capital
 - stakeholder capital
 - and strategic governance.
 - Ratings were modeled after bond ratings using a AAA (best) to CCC (worst) rating scheme.



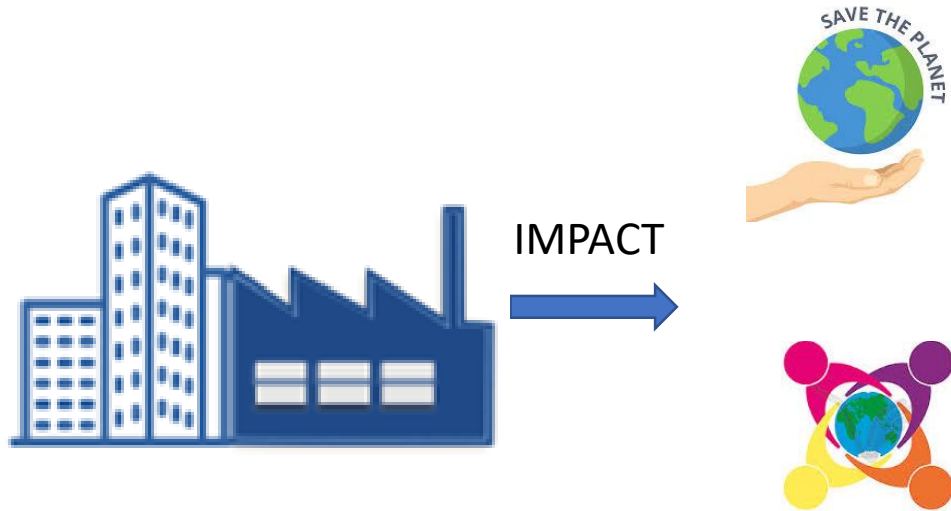
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Conceptual spectrum of ESG ratings & their users

	Values-driven purpose	Value-driven purpose
Audience	Socially responsible and ethical investors (e.g., who embed in their decisions moral ideals of justice, fairness, equity)	Mainstream investors who integrate ESG factors in their investment decisions
Objective	Capturing social and environmental externalities (e.g., positive and negative impacts whose costs and benefits do not have immediate financial implications for the business)	Capturing social and environmental dependencies (e.g., risks and opportunities with financial implications for the business)
Underpinning materiality concept	Impact materiality	Financial materiality

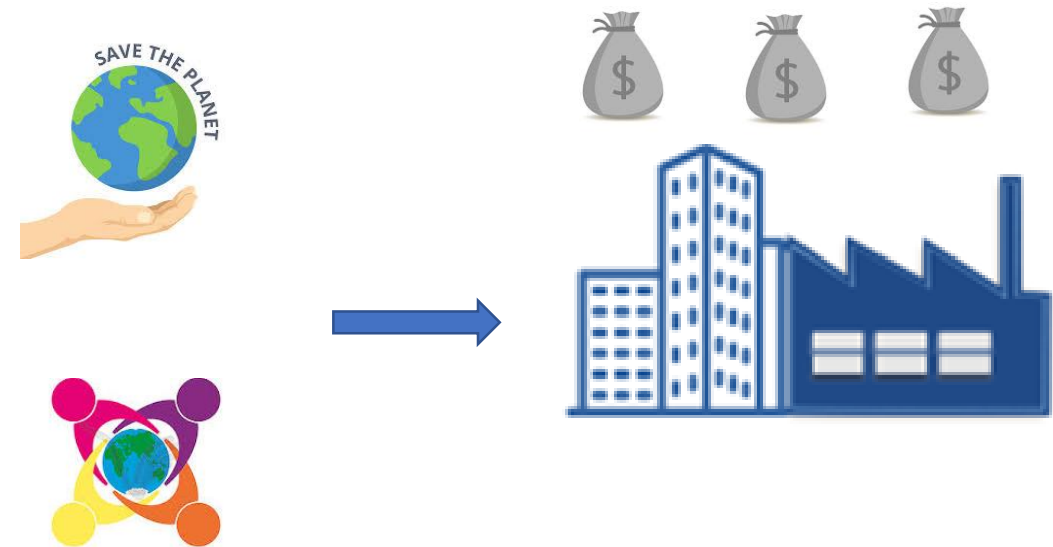
A different lens (+/- 2010)

The roots – Accountability perspective



Primary audience: all stakeholders

The new lens – Financial perspective



Primary audience: all capital providers



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Ratings & frameworks

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What about VE and Sustainalytics

- **Double** materiality perspective
- BUT following **pressure from mainstream investors** Sustainalytics shifted towards an ESG Risk rating, and thus **towards a financial materiality perspective**
 - Investors do not use ratings blindly or at face value, they **prosume** them (Toffler 1980, Knorr Cetina 2010)
 - Prosumption: producing while consuming
 - Following their prosumption they may demand some changes in the ratings so that they can better use them to suit their needs
 - ⇒ **Co-production:**
 - ⇒ constant interaction, feedback between elite analysts and rating providers

**Important difference with
Espeland & Sauder's
work:**

Students use ratings at
face value



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Recent developments: different products for different users

Impact ratings

SDG ratings

Carbon risk
ratings

Controversy
products

EU action plan offering

Taxonomy
Ratings

Portfolio
reporting tools

...



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Investors taking the lead

- Demanding rating providers for “DATA”
- Creating their own **customized** rating, reflecting their own taste
 - *So if a client has a preference for a particular issue, wants to weigh that particular issue higher, wants to remove a particular issue, they can drill down into the scores and maybe **recreate or create their own model using our data and our underlying scores.** (RA1b)*
 - ***There’s a menu – a supermarket** – you pick what you want, and then you have a tool to put everything on the same vector space. So, basically, if you’re looking at a yes/no, we then rescale it on a 0 to 5 scale or whatever you pick, and then everything is then calculated into a score, and then you can then create a rating after that, depending on how you wanna – so, it’s – in that sense, it’s a very powerful tool for the more sophisticated investors that want to go beyond. (RA3c)*



So, what about sustainability ratings providing norms, creating reactivity?

- Rated companies know investors “prosume” the ratings
- Companies search for common denominators among the ratings, to which they then may respond by conforming
 - Why? Common ratings are those that investors are really interested in
 - Shift towards financial materiality view in companies

[Co12] was really defining sustainability from an environmental standpoint what's our footprint? where are we doing bad?, and how do we set targets from a reduction standpoint? [...] in the last five years we've had a little bit of an evolution, from a thinking standpoint, of trying to think of it a little more strategically of how do we look at some of the social and societal issues that will become material risk for our business, [...] and how those things may affect our ability to operate and be profitable, [...] a little bit more from a business strategy standpoint, and less transactional, of quantifying the bad and doing less bad, as I used to call kind of the first citizenship CSR.

- **Governing scope** of all ratings seems to be restricted to **financial materiality items**



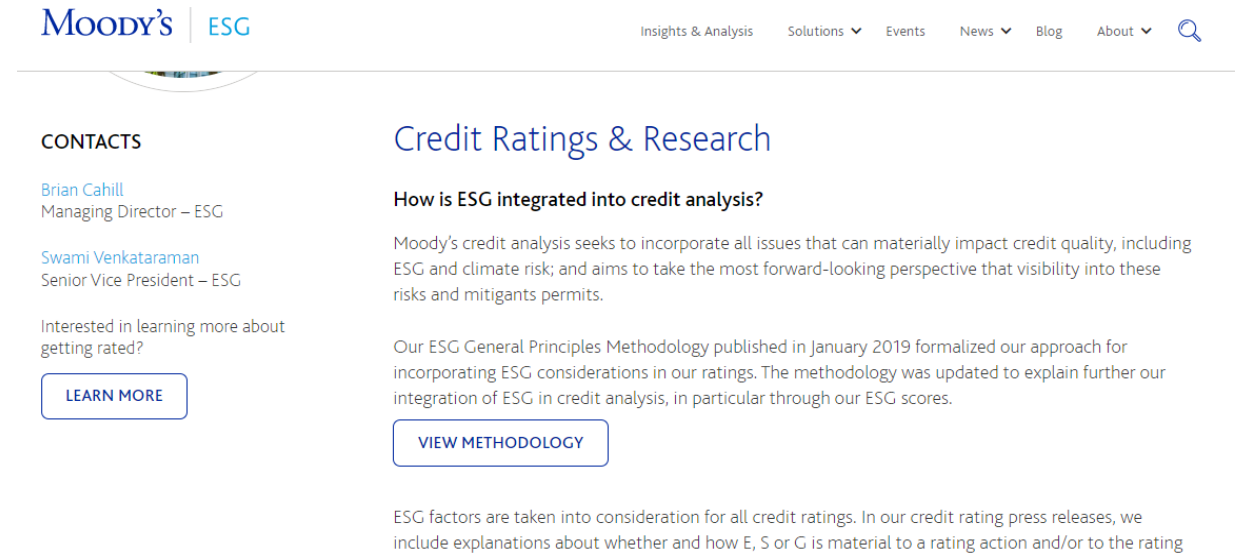
So, what about sustainability ratings providing norms, creating reactivity?

- Customization activities direct companies' reactivity efforts towards those ESG items that are weighted and followed-up heavily by their analysts.
- This makes “gaming” behavior not possible or more likely to be detected
- This type of presumption **increases the governing power of specific ESG items** as these are now leveraged in the discussions between analysts and companies.



Future?

- How will the ESRS, promoting double materiality, influence this eco-system?
- How will IFRS SDS, influence this eco-system?
- Will ESG risk ratings disappear and be included in credit ratings? How will this influence this eco-system?



The screenshot shows the Moody's ESG website. At the top, the logo "MOODY'S | ESG" is on the left, and navigation links "Insights & Analysis", "Solutions", "Events", "News", "Blog", and "About" are on the right. Below the header, the "CONTACTS" section lists Brian Cahill (Managing Director – ESG) and Swami Venkataraman (Senior Vice President – ESG), with a "LEARN MORE" button. The "Credit Ratings & Research" section has a heading "How is ESG integrated into credit analysis?" followed by a paragraph about Moody's credit analysis. Below this is a "VIEW METHODOLOGY" button. At the bottom of the section, a paragraph states that ESG factors are taken into consideration for all credit ratings.

MOODY'S | ESG

Insights & Analysis Solutions Events News Blog About

CONTACTS

Brian Cahill
Managing Director – ESG

Swami Venkataraman
Senior Vice President – ESG

Interested in learning more about getting rated?

LEARN MORE

Credit Ratings & Research

How is ESG integrated into credit analysis?

Moody's credit analysis seeks to incorporate all issues that can materially impact credit quality, including ESG and climate risk; and aims to take the most forward-looking perspective that visibility into these risks and mitigants permits.

Our ESG General Principles Methodology published in January 2019 formalized our approach for incorporating ESG considerations in our ratings. The methodology was updated to explain further our integration of ESG in credit analysis, in particular through our ESG scores.

VIEW METHODOLOGY

ESG factors are taken into consideration for all credit ratings. In our credit rating press releases, we include explanations about whether and how E, S or G is material to a rating action and/or to the rating



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Take-aways for future academic work

- Study ratings and reporting frameworks together
 - Robson and Ezzamel (in press): this may provide insights into the cultural fields of accounting practices
- Prosume ratings when using them to further theoretical development
 - Select items to build a construct based upon theory
 - *“The most naïve users we had for our data was the academics. They were worse than the investors, worse than the worst of the investors.”* (B)
- Take fact that investors prosume into account when studying the financial impacts of ratings



Thank you!



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