Louvain School of Management
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# ESG Rating Agencies: What is the Path towards a Bright Future?

Research Master's Thesis submitted by
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*Hoping that you enjoy your reading, I also want to allude to my interest in this area, which has undoubtedly increased during the execution of this Thesis. I can now see myself in this area in a not so far future, and look forward to further develop my knowledge about it.*

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# 1. INTRODUCTION

*"As wealth shifts and investing preferences change, environmental, social, and governance issues will be increasingly material to corporate valuations."* (Fink, 2019)

This thought comes from Larry Fink, BlackRock's CEO, on its 2019's Annual Letter to CEOs. BlackRock being the world's largest asset manager, with $6.5 trillion in assets under management (BlackRock, 2019). The increasing importance of ESG (Environmental, Social and Governance) into investments is thus clear, along with the current shift in investor's demands and preferences.

## 1.1 Background

Back in 2015, in his book *On care for our common home: The encyclical of Pope Francis on the environment, Laudato Si'*, Pope Francis had already launched a pressing challenge to protect our common home, which included the concern to reunite the human family in the search for sustainable and integral development. He addressed an urgent invitation to renew the dialogue on how we are building the future of the planet.

Focusing on the binomial of creativity and power in technology, he reminds us that we are the repository of abysmal waves of change, from the areas of communications, to industries, to medicine, to computing, and more recently to the digital revolution, with robotics, biotechnologies, and nanotechnologies. The efforts of scientists and technicians are notable, who have developed alternatives for sustainable development.

However, humanity has never had so much power on itself and nothing guarantees that it will use it well. There is a lack of instruments to control this power, other than superficial mechanisms. Pope Francis further affirms that Men need a solid ethic, a culture and a spirituality that really sets a limit and contains him within a lucid version of himself. In addressing the technocratic paradigm, Francis emphasizes Man's tendency to exercise his dominance over the economy, turning all its technological development into profit, without paying attention to possible negative consequences for the human being which, in my opinion, is mirrored in several companies.

After this brief incursion into Francis's Second Encyclical, in which he wisely equates and questions how we are constructing the future in the light of Sustainability, alerting us to the need to have true control mechanisms in this field, it is with great conviction that I say that the role of ESG Rating Agencies (ESGRAs[1]) is now of great importance and will be more and more in the future. The 26% representation of Sustainable Investments in all investments in the United States and their global growth of 34% in the last two years (GSIR, 2018), along with 86% of millennials saying they are interested in Sustainable Investing (Morgan Stanley, 2017), leave little room for any doubt about the importance of ESGRAs.

It is undoubtful that companies are investing in Sustainability, as they know this is valued by both their clients and investors, but the truth is there is Green Washing in the market (Furlow, 2010). The need for external entities supervising and evaluating whether a firm is truly sustainable was evident, and the appearance of ESG Rating Agencies came in as natural. These were later indeed proved to being successful in deterring companies from Green Washing practices (Parguel, Benoît-Moreau, & Larceneux, 2011).

[1] The term ESGRA will be used during this Research to refer to ESG Rating Agencies

## 1.2 Research Focus

Since then, the market of ESG Rating Agencies has been growing and is now more mature, although still in an initial phase, and a number of mergers and acquisitions has already taken place (Mooij, 2017).

Interest in this market is big, with Sustainable Investments also increasing in the last years (GSIR, 2018). Competition is high, without the existence of truly accepted big players, nor standards, nor best methodologies. Everything is still open, and opportunities are all around. Moreover, the demand from investors on ESG data has caught the attention of the big, traditional, Credit Rating Agencies (CRAs[2]), which are starting to enter the market (PRI, 2017). The latest example of that is the deal between the CRA Moody's and the ESGRA Vigeo Eiris.

It thus proves to be truly contemporary and captivating to think about what might be the future scenario of the market of ESG Rating Agencies and how can these strive in it. Predicting is surely a tough task, but this can be done by reflecting on the path to success that these Agencies will need to take. Moreover, scrutinizing the opportunities and challenges of ESGRAs, plus what they should focus on to overcome these challenges, will provide insightful ideas towards picturing the future of this market. Not only that but also relating the entry of CRAs in the market with the existence of ESGRAs should also produce compelling clues to the end result.

Very few studies tried already to reflect on the future of ESGRAs and what is their path to success. Forward-looking studies in the literature are lacking in what regards the future state of the market of ESGRAs, as the most common focus on current challenges and problems faced by these agencies. Also, the relationship or possible relationship between ESGRAs and CRAs stands as a gap in the literature, mostly because even though the entrance of CRAs in the ESG

[2] The term CRA will be used during this Research to refer to Credit Rating Agencies

field is currently being analyzed, the actual relationship seems to be put out of the plate by practitioners. Moreover, public thoughts from individuals inside these agencies are not so common, meaning significant insights will be achieved during the research.

## 1.3 Objectives

Having stated this, the objectives I propose to achieve with this dissertation are:

1- Predict whether the future of the market of ESG Rating Agencies is bright;
2- Assess the possible relationship between CRAs entering the market and existing ESGRAs;
3- Reflect on the opportunities and challenges of ESGRAs;
4- Understand the path to success of ESGRAs;

## 1.4 Disposition

The Research Focus will be addressed firstly through a chapter on the relevant Literature Review, which will let the reader be more familiarized with the concepts and present thoughts on the market. The Methodology will then be explained, where interviews will be covered in more detail. Right after, these will be Analyzed, one by one, to then be Discussed on the major points brought up and agreed on, while also pointing out controversies detected. The final chapter will consist of the Conclusion, with a wrap up of the most important findings, to also address the objectives initially proposed while some personal thoughts are added. The chapter ends with the Limitations and Further Research.

# 2. LITERATURE REVIEW

## 2.1 Sustainable Investing

It is undoubtful that the interest in Sustainable Finance has been growing in the last few years. Sustainable investments have grown 34 percent in the last 2 years across the five major markets (GSIR, 2018) and these assets stood at the beginning of 2018 at $30.7 trillion. Europe continues to be the main player of this type of investments, with a representation of 46% of the market. However, this denotes a decline in the proportion, as in 2016 this value was of 53%. Other regions have now also started to enter exponentially in the market, with regions such as Japan, Australia, and Canada having very fast growth during the last two years. The US has now a percentage of 39%.

BlackRock (2018) made a text analysis of earnings call transcripts from S&P500 firms and concluded that the average number of ESG-related terms went from 6 a decade ago to 10 times per conference. Moreover, according to a 2019 Report from SustainAbility, "in 2018, one in every four dollars invested in the US was aligned with a sustainable, responsible or impact (SRI) investment strategy, primarily thanks to widespread ESG incorporation in investment vehicles".

Still, this practice of Sustainable Investing[3] has been practiced for centuries by faith-based organizations, with it gaining strength in the 1960s as concerns for the environment and more specific incidents such as the Vietnam War took place, resulting in political activists aligning their investment strategies with their social and political principles (ACCF, 2018). Over the years, investors grew interest in this type of investment as they were seeing how they could affect corporate behavior. A quite fascinating example is the one of the ending of Apartheid, which was stimulated by the avoidance of investment in South Africa in the 1980s

[3] Throughout this Thesis, the term Sustainable Investing is used as an inclusive definition, not distinguishing it with other similar terms such as Responsible Investing and Socially Responsible Investing.

(MacAskill, 2015). Additionally, more recent political movements also prove the growing interest of the general society in sustainability issues. The Paris Agreement, signed in 2016, is one example, where the main long-term goal is to maintain the increase in global average temperature below 2 ºC and to also limit this increase to 1.5 ºC, thus reducing the effects and risks from climate change (Falkner, 2016).

### 2.2 Motivations for Sustainable Investing

A report from Deloitte from 2016 states that 57% of the investors were already considering integrating ESG issues into the investment process and analysis. All this interest in Sustainable Investing did not come from anywhere, and there are some explicit motivations from investors for it.

A questionnaire done in the United States in 2018, by US SIF, to asset managers on why they are incorporating ESG criteria in their different investment processes showed as the main reason client demand. Other motivations stated in this study were the fulfillment of mission or values, the pursuit of environmental or social benefits, the gain of improved returns over time, and finally the reduction of risks aligned also with the fulfillment of fiduciary duty. The implementation of one or more UN Sustainable Development Goals was also cited as a new, minor motivation.

This corroborates what was said in the 2016 GSIR Report, where fiduciary duty was stated as one of the great catalysts of Sustainable Investment, along with Pension Funds, saying that it is essential to long-term investing and risk mitigation. Concerns and actions on climate change were also reported to be another main driver.

The BlackRock report of 2018 on Sustainable Investing goes along by saying that sustainable strategies are growing in popularity, driven especially by the desire from investors to do good, access niche market catalysts and better mitigate risk.

A closer look at the literature says that the actual companies gain with sustainability, which will then result in a better performance from the company and an interesting investment for the future. These gains translate to better resources being obtained (Waddock & Graves, 1994), marketing of products and services improved (Fombrun, 1996) and higher quality employees (Turban & Greening, 1997). Corroborating these points is the more recent *2030 Purpose: Good business and a better future* Report from Deloitte (2017). There, it is said that companies committed to wider social good are the ones better prepared to retain talent in the future, one of the biggest challenges for companies nowadays. Moreover, consumers are also influenced by this fact, as they will be more willing to put a bigger share of their wallet into the socially engaged brand. Not only that, but Deloitte also reports that sustainable companies will achieve great savings in their supply chains.

A report published by Eurosif in 2008 states as a bonus motivation the external pressure from NGOs and media.

A very relevant remark is made in Part 2 of PRI's Report (2018), where it is said that risks that were historically supposed to be long term are now emerging in the short-term horizon as well. These risks, which were perceived to be still far from being material enough to impact a company, are now very close to doing so in terms of cash flow and funding ability. The main example is said to be climate-change related incidents, both in terms of severity and quantity. The other example is governance, as nowadays companies need to be on their toes to be able to respond to any change in policies, which happen with more speed and frequency.

## 2.3 Types of Sustainable Investing

On Sustainable Investment, there are several different strategies:

- Negative Screening – Characterized by the act of excluding from a portfolio or fund certain sectors, companies or practices,
- Positive Screening – Selection of great ESG performance companies related to industry peers,
- Norms-Based Screening – Taking into account minimum standards of business practice based on international norms,
- ESG Integration – Inclusion of environmental, social and governance factors into the financial analysis,
- Sustainability Themed Investing – Investing in themes or assets or industries specifically related to sustainability,
- Impact Investing – Investments in projects aimed at solving environmental or social problems,
- Corporate Engagement and Shareholder Action – Using the shareholder power and position to influence corporate behavior.

Negative Screening came in as the most practiced strategy in Europe, through the 2018 report from the Global Sustainable Investment Alliance. Looking at the United States, this place is taken by the ESG Screening strategy. It is also important to note that this strategy has been the one with the highest growth across all strategies during the past two years.

## 2.4 Asset Allocation

The report of GSIR of 2018 also shows very interesting data regarding the asset allocation of Sustainable Investments, and a tendency to change. Public Equity is the principal class, with a weight of 51%, while Fixed Income also has a big representation in the mix (36%). And this shows a change, as two years ago Fixed Income accounted for 64% of sustainable investment assets, being this just another reason for the growing importance of sustainability ratings of companies. Then, other asset classes are starting to be noticeable as well, such as Real Estate, which got 3% of the total sustainable investment assets.

## 2.5 Institutional vs Retail Investors

A meaningful distinction done in the 2018 GSIR is between institutional and retail investors, a classification also given to the investments managed by asset managers. Being institutional investors the ones with higher minimum investment levels, such as pension funds, foundations, and universities, while retail investors make personal investments, thus these having generally lower minimum investment levels. It is known that institutional investors dominate the market, but the truth is retail investors have been showing a higher and higher interest in sustainable investing, which has accomplished a growth in the weight of retail investors in sustainable investing for the last years (25% in 2018 against 20% in 2016), through the same GSIR Report. Although this phenomenon can be attributed to the rise of millennials investing (EY, 2014), it is also true that sustainable investment is not an easy strategy for a normal retail investor due to its high costs (Hvidkjær, 2017).

## 2.6 ESG Rating Agencies

From the Part 2 of the PRI's Report (2018), the definition for ESG Scores and ESG Rating Agencies is given as companies that "evaluate a security issuer (either of bonds or equities) according to their exposure and performance relative to ESG factors and compared to their peers". These indicators given are quantitative and paid for by investors.

A big objective for ESG Rating Agencies, which can also be seen as a mission, is simply promoting SRI in all respects, with a stronger impact on ESG Screening (Schäfer, 2005).

These agencies try then to solve two problems (Chatterji & Levine, 2006): the first is to help the company, top managers, board of directors, understanding whether valuable long-term assets and relationships are being created. These non-financial performance metrics can be extremely important for a reliable analysis of the company. The second talked about, aligned with the first, is to help the other side of the spectrum, represented by customers, regulators or potential employees to better know the social performance of the company. The external pressure is surely important for companies and they will change their habits and actions according to it. Not only getting to know the companies better but identifying business risks proves to be a very important aspect too (Schäfer, 2005).

They offer a big range of services, along with providing ratings. Thematic reports on sectors, Benchmarks, Assistance with corporate engagement programs, Portfolio screening, Training courses (Escrig-Olmedo, Muñoz-Torres, & Fernandez-Izquierdo, 2010). Moreover, controversy alerts and engagement services are reported to also be part of the range of activities provided (Novethic Research, 2013).

## 2.7 Rise of ESG Rating Agencies

Through the increasing importance of the implementation of responsible corporate policies, the importance of ESG Rating Agencies has been on the rise as well (Escrig-Olmedo, Muñoz-Torres, & Fernandez-Izquierdo, 2010). Along with this, socially responsible financial markets are growing, and investors demand more information.

Another point for this rise of this type of Agencies is brought up by Schuler & Cording (2006), as information provided by external sources on the performance of a company has a greater impact on consumers than provided by the company itself, thus giving a major role in Sustainable Investing to ESG Rating Agencies.

Moreover, nowadays the services of ESG Rating Agencies are used by the largest investment firms, such as BlackRock. And a big chunk of this adoption comes from the United Nations Principles for Responsible Investment (PRI), which as of 2019 has 2300 signatories. It promotes the incorporation of ESG practices in the investment decisions of asset managers and is a big initiative from the United Nations onto Responsible Investment. Since these commitments are costly in terms of money and time, many asset managers do not have the resources needed to conduct ESG Research in-house, resorting to ESG Rating Agencies to execute this service (ACCF, 2018).

On a Report by SustainAbility from 2018, one of the main reasons for which nowadays companies use and are interested in ESG Ratings is because they facilitate the identification of emerging issues and the benchmark of the performance of their peers in sustainability terms.

## 2.8 Financial Performance vs Sustainability

A heated debate is the one whether ratings on ESG and companies with a strong ESG profile actually have better financial performance.

An interesting study was the one done by Eccles et al. (2014), where U.S. firms that embraced corporate policies related to social and environmental issues before these became general were analyzed. After comparing to similar peers in terms of financials and size, but which did not adopt such policies, they could conclude that the "sustainable" companies outperformed the others through the long-term. Moreover, companies with better sustainability performance were found to have lower alphas in recent years, which also validates the belief that financial performance is improved through sustainability (Borgers et al. 2013). Another example is the study from Dimson, Karakas & Li (2014), where they showed that after successful initiatives on the social/environmental side, companies end up with better governance and accounting performance, key drivers for financial performance.

Many other studies have been done to explain what a strong ESG company means to its financial performance, given by MSCI (2017) the name of company-specific transmission channels. There are three:

- The first one is called *Cash-Flow Channel* (Gregory, Tharyan, & Whittaker, 2014) and explains that companies with a strong ESG profile will be more competitive than their competitors (for the several reasons already seen above), and will thus develop strong long-term business plans, which will translate in a competitive advantage, leading to higher profitability and higher dividends.
- The second is *Idiosyncratic Risk Channel* (Oikonomou, Brooks, & Pavelin, 2012), where a strong ESG company will have improved risk control and compliance methods, which almost work as insurance against severe events and in the end, there will be less frequent risk incidents leading to losses in the stock price.
- Thirdly, the *Systematic Risk Transmission* Channel (Ghoul, Guedhami, Kwok, & Mishra, 2011) claims that companies with a strong ESG profile are less exposed to systematic market risks, which translates into a lower cost of capital and rate of return required by investors, transforming into a larger investor base and thus a higher valuation of the company itself. The same report of MSCI made a 10-year back test with monthly rebalancing of the five ESG quintiles portfolios. This resulted in the conclusion that companies with better ESG ratings slightly outperformed the ones with worse ratings.

In their *From the Stockholder to the Stakeholder* Report (2015), Clark, Feiner & Viehs analyze several studies regarding sustainability and financial performance of companies. They make some interesting highlights such as 90% of the research on the cost of capital show that good sustainability levels make up for a lower cost of capital, 88% of the studies conclude that operational performance is positively influenced by ESG practices, and 80% of research defends that good sustainability practices result in better stock price performance of companies.

Another quite interesting study is the one done by Aktas, Bodt & Cousin, where in the period from 1997 to 2007 they investigated 106 international merger deals to assess whether acquiring a company with a strong CSR culture would be well seen by the investors. They arrived at the conclusion that indeed the reaction of the market is positive when companies with a good profile on sustainability are acquired.

Talking more specifically about ESG Ratings, some research (Halbritter & Dorfleitner, 2015) using samples provided by ASSET4 and Bloomberg proved that ESG Ratings were positively related to returns in the 1990s, with this relation disappearing then in the 2000s, suggesting investors started to understand the connection. Then in the period until 2012, there was no evidence that high ESG Ratings led to lower returns. In a study from Larsen (2016) on ESG Scores between 2012 and 2016 with data gotten from MSCI, strong positive correlation to returns was reported. Moreover, Larsen also found a lower standard deviation for stocks with good ESG Scores.

On the other hand, there are also some studies on the literature that show opposite results. In a study comparing socially responsible mutual funds to conventional funds in the 1997-2005 period (Rodriguez, 2010), no outperformance was found from socially responsible funds. Another example is an analysis between high ESG scored funds and U.S. domestic mutual funds from 2012 to 2016 (Dolvin, Fulkerson, & Krukover, 2017), which concluded that high sustainability scores funds had similar risk-adjusted returns to the other fund. A third example, claiming the underperformance of Sustainable Investing practices, was done between 2005 and 2014 using a sample of 1000 firms from the US, Europe and Asia (Ciciretti, Dalò, & Dam, 2017). They came up with the result that using ESG strategies accounts for a cost to the investor of 4.8% annually in risk-adjusted returns. And these are just a sample of the several studies in the literature arriving at similar conclusions.

In a research done in 2017 by Søren Hvidkjær, he reflects on reasons for both possibilities of outperformance and underperformance of SRI/ESG investment strategies. The lack of reaction from the stock market to ESG information is given as one of the main arguments for it, in the sense that the positive effects from an ESG event are not sufficiently taken into account by investors, which translates for an undervaluation of the companies at the time of the event and very good investment opportunity for the future (when the investors finally recognize the event and abnormal high returns are obtained). The valuation, or non-valuation of intangibles, comes related. Intangibles are harder to value and more uncertain, and especially not so notable to investors. Sustainable investments by firms are typically intangibles, and the same undervaluation of the stock is caused by investors.

Hvidkjær continues with a second reason, claiming that the sudden popularity of ESG stocks might be causing their overperformance, as the investor demand for this type of stock starts to grow and the buying spree continues even if not a lot of information exists to justify the new valuation of the stock.

The author then tries to explain why Sustainable Investment strategies might underperform other strategies, through the high costs of ESG Screening. Passive investors usually give a lot of importance to additional costs, and passive investment strategies are becoming extremely popular, almost overcoming actively managed funds in the U.S. (Cox, CNBC, 2019). These high costs will result in low returns to ESG Investing, something not affordable for passive investors.

A final, quite extensive study, is the one done by Marianne Brunet (2018), where dozens of studies from academic literature and industry research experts were analyzed, dating as back as 2010, on whether sustainable investing is a good bet. It concludes that lately there have been published more studies arguing Sustainable Responsible Investing strategies can deliver risk-adjusted returns to investors, but the still considerable presence of literature saying otherwise makes up for a lack of consensus about this investment strategy performance. It adds that it is still too early to draw conclusions through empirical tools for SRI/ESG performance along the different asset classes.

### 2.9 Challenges for ESG Ratings and ESG Rating Agencies

Data on ESG has surely improved throughout the last years, although it still has a long way to go and many challenges to overcome. A strong statement done is that “blindly relying on ratings is not a good idea in any case, as rating agencies make mistakes” (Mooij, 2017). From the 2018 Blackrock Report on Sustainable Investment, ESG-related data are still inconsistent, and some issues are more useful (or material) than others, meaning that aggregating everything in a simple number can prove to have its own problems. Moreover, this report identifies four main drawbacks for the existing ESG data.

- Quality

As the data is usually self-reported leaving the door open for inconsistency and unreliability. Company disclosure needs to be higher along with the existence of standard reporting frameworks. The latter should even be the first step towards improvement, through a set of industry-specific standards, with enough granularity that they are enough broad and meaningful for a good comparison between firms. A report from Deloitte dated 2016 stated nearly 80% of the investors remain dissatisfied with the fact that companies in the same industry remain with a low level of comparability in sustainability reporting. Comparability and consistency are indeed seen as the top priority for the future of ESG Ratings by investors (SustainAbility, 2019).

A study of 2015 by Khan, Serafeim, & Yoon showed the importance of well figuring out which sustainability issues are material and which are not. Firms with better performance on material sustainability issues were concluded to outperform the ones with worse performance on sustainability issues that are material. The classification was done through the accounting standard setter Sustainability Accounting Standards Board.

These metrics are also said to not be reliable, valid or comparable (Chatterji & Levine, 2006), which can lead to harm overall welfare and corporate social performance. By reliable, the authors say that another test should give the same result, and by valid that it describes well the correct dimension of social responsibility, here also aligned with materiality.

On Transparency and Disclosure, Jim Hawley (2017) states three biases:

1. Geographical Bias: With ESG being more developed in Europe, the tendency is to use the standards from there. Moreover, disclosure requirements are higher in Europe than in any other region (ACCF, 2018);
2. Factor Bias: Usually there is no disclosure of the weighting given to each ESG category;
3. Selection Bias: Towards investors or stakeholders, in the way that there is a bigger tendency of awarding big companies with high ratings, as these report on more ESG factors, almost making this a “check the box bias”. This can also

be due to a higher financial power which translates into more investments to improve their ESG profile (Gese, Lee, Melas, Nagy, & Nishikawa, 2017).

This study also suggests that there is limited research on what data sources are used and how by the ESG Rating Agencies, which might be due to most raters trying to protect their intellectual property and data sources.

Then, a quite fascinating fact is raised in a report by BlackRock in 2016, where they mentioned that companies with regulatory issues and business ethics controversies were more likely to have a higher degree of disclosure of ESG-friendly policies. Moreover, in their 2018 Report, ACCF confirms this by saying that companies with weak ESG practices can still score a high ESG Rating as long as they have a strong disclosure.

- Coverage

It is easy to understand why, as most of the data on ESG is quite recent, while mostly only big firms report comprehensively on their sustainability issues.

Indeed having a rating in ESG proves to be a lot of work to companies, and a lot of costs that customers and stakeholders will have to bear (Chatterji & Levine, 2006). According to the same authors, these cover filling endless forms, explaining safety procedures, visits from compliance auditors, thousands of pages of surveys each year on their social, environmental, governance and ethics policies. It is then also hard for stakeholders to identify which codes and standards are reliable measures of social responsibility when there are so many out there. Not only this, but the authors continue by suggesting that with so many different questionnaires and surveys, it proves to be impossible for companies to answer to all, causing them to ignore some and not answer as detailed as they could, as they are doing that every time and then motivation and utility from it is seen as not great.

Chatterji & Levine (2006) add that the number of institutions giving out ratings can even make the consumer and stakeholder confused as they don't know what to look for and what is actually right or wrong.

- Consistency

Each metric of ESG is given a different weight. Indeed, the methodology of the different ESG Rating Agencies is different and thus the scores given have quite a low correlation. A number of studies state this problem as a lack of standardization throughout the market (Escrig-Olmedo, Muñoz-Torres, & Fernandez-Izquierdo, 2010) and not one method is thought to be right, along with little evaluation of the multiplicity of approaches which lead in the end to no comparability (Hawley, 2017). However, there are some who say dividing points between each of the categories could be convenient (Chatterji & Levine, 2006).

It is also said that "normalized" ratings might under- or over-weight a company or even an industry, as company and sector-specific risks are not taken into account in the analysis, making it redundant (ACCF, 2018).

Another fact worth mentioning is the weak correlation that exists between ESG Rating Agencies (Wigglesworth, 2018). CSRHub, a data provider for the sustainability industry, calculated the correlation between the ratings of MSCI and Sustainalytics, two of the most important agencies, to be at 0.32. As a comparison, the correlation calculated between the Credit Rating Agencies S&P and Moody's was 0.9.

- Frequency

Most of these ESG metrics are only updated once per year, which makes it harder for investors to rely on this data as they need timely data to let them manage risk and enhance returns. Also is referred that there are some delays in reporting, making it hard for companies to obtain the data in time (Hawley, 2017).

## 2.10 Suggestions

For a Rating to be perceived as having high quality, the key factors are trustworthiness and transparency of data sources along with the robustness of the methodology, according to the 2019 SustainAbility Report.

Knowing all the current problems and challenges, a solution suggested by Escrig-Olmedo, Muñoz-Torres, & Fernandez-Izquierdo (2010) would be the creation of a standard rating system that homogenized all criteria so that firms could be rated in all aspects of sustainability. Moreover, on weighting the different metrics of ESG, an idea is proposed by Chatterji & Levine (2006) where they say the best solution would be to let investors do by themselves the weighting to each category, according to their strategies, and thus create their unique portfolio. This is a quite interesting alternative: to just give ratings per criteria and not a full rating. By this, there is more transparency, and everything is detailed and showed. The investors can then choose what they want to value more and give a bigger weight accordingly. This is also backed up by Jim Hawley (2017), as he adds that data should be available in 'raw' form, following what happens with financial data.

On this aspect, literature (Chatterji & Levine, 2006) states that all methodology, especially survey instruments and the relative weights for each metric, should be detailed and disclosed. Moreover, the inclusion of case studies of specific companies is suggested, to show the whole process and why they were selected, and also show one that wasn't selected, for comparison. The authors also talk about having industry-specific criteria and measures, as this is not a one-size fit all kind of business. Here, ESG Rating Agencies should also adjust their rating methodologies to address different industries, beginning with the weightings given to each ESG (ACCF, 2018). Also, importance is given to the intellectual property, as this is the main problem to be able to achieve a solution in the theme of transparency. Jim Hawley (2017) suggests there is no easy way around this protection problem.

On how to better measure the Materiality of each risk and ESG factor, the Part 3 of the PRI’s Report (2019) focuses on four main points to assess: Visibility, so how noticeable and obvious they are; Probability of the risk materializing; Timing, meaning when and how they are expected to occur; and Severity on what is the expected impact on the company as a whole. Then, the report goes on by giving some suggestions to better make these assumptions, being scenario and sensitivity analysis two of the main ones. It might indeed help to think about how the company would react to a range of hypothetical outcomes, to then also assess the impact on the company by only changing one single ESG variable at a time. Not only this, but the alignment of ESG categories to financial performance is regarded as crucial for the future (SustainAbility, 2019).

Regarding the several biases described, the ACCF Report of 2018 states that ESG Rating Agencies should treat the absence of information critically, and to do so they should adapt their methodologies to the different quantities of information and data present in each geography and industry.

Then on the High Costs for companies to answer so many questionnaires and all the information required by agencies for them to be able to do their job, the same authors suggest that globally accepted certifications should be reached, so that companies only have to go through the process of being assessed whether they have a good ESG culture in each topic only once. Then, common questionnaires are also mentioned, as they will lower costs and have a higher response rate with better data quality, although this is a hard to imagine reality, as all agencies compete with each other.

## 2.11 Credit Rating Agencies

According to Escrig-Olmedo, Muñoz-Torres, & Fernandez-Izquierdo (2010), Credit Rating Agencies specialize in the analysis of shares and companies, to then "make conclusions about the ability of a company to meet its financial objectives in the short and medium term, which are then summed up in a rating". These agencies have achieved a crucial and trusted position in the capital markets to investors. They also provide sovereign ratings to measure the risk that a government may default on its own obligations (United Nations, 2008).

A big difference between Credit Rating Agencies and ESG Rating Agencies is the fact that the ratings in the Credit side are solicited by the companies, or the issuers, while in the ESG side these are usually unsolicited, as they work in an investor demand way (Schäfer, 2005).

## 2.12 CRAs on ESG

From the Part 1 of the PRI Report (2017), it is clear that CRAs are already moving towards ESG initiatives. Research publications on ESG are already being published by the biggest Credit Rating Agencies with the objective of improving methodologies and transparency and approaching client demand. Moreover, risk management is reported as the most important driver to incorporate ESG issues in credit risk analysis.

Still, there are some clear challenges, being the first and main one the willingness of investors to pay for non-rating ESG oriented products and services. Other than that, the lack of understanding of how ESG issues impact corporate yields and the non-existence of data which is comparable and historical make for the other challenges (PRI, 2018).

## 2.13 Future of ESG Rating Agencies

Nowadays, the market has a big number of ESG Rating Agencies, with each one using a distinct methodology, thus suggesting a process of mergers in the future (Escrig-Olmedo, Muñoz-Torres, & Fernandez-Izquierdo, 2010). The authors continue by indicating that the strongest agencies in the market will lead this process, as their ultimate objective is survival in the market.

Not a lot is said in the literature regarding the future of the market of ESG Rating Agencies, suggesting it is a quite hard topic to think of and try to predict. Still, one thought that seems to be general is the fact that once rating schemes are well developed and standardized, they will greatly impact on corporate behavior (Dillenburg, Greene, & Erekson, 2003).

Schäfer (2005) adds the possibility of the emergence of provider structures with similarities to those of the international Credit rating market in the ESG rating market. He continues by pointing out that there might even be vertical integration with these credit rating agencies. On the point of CRAs, PRI makes some relevant remarks on its *ESG, Credit Risk and Ratings* Report of 2017 (Part 1). The growth in demand from investors for more guidance from CRAs, especially in consideration to ESG, and even the demand for the inclusion of scenario analysis to assess trends and risks in the future, are making CRAs take ESG more in consideration.

On more recent research, Avetisyan & Hockerts (2017) suggests that the ESG Rating Agencies market does not follow a standard industry life cycle, as there have been already not only mergers between purely ESG players (further detailed in Chapter 4.1.4), but also between ESG Rating Agencies and broader data providers. This has resulted in a quite fragmented market with a few big players, where entry is difficult both from this and from the complexity of the industry. As such, one of the main benefited parties is the customer, as consolidation means stronger entities with more likely survival in the long-term. Then this also contributes to more standardized data as finally there are appearing the big and respectable players in which investors can trust and look at as an example. On the other hand, consolidation is seen skeptically by some investors, with the main reason being competition brings overall quality from the several players present in the market.

This research indicates as well that, when talking about local small ESG Rating Agencies, the only way to survive and grow in such a market will be joining other already "established ESG Rating Agencies, asset management companies, brokerage research organizations or even Financial Rating Agencies".  Finally, the possibility of an innovative industry in the field of ESG Ratings is left open, with these agencies spread over the world and specializing in specific industries.

A relevant question, brought up by Søren Hvidkjær (2017), is left in the air: how close are we to a steady-state level of Sustainable Investing?

## 3. METHODOLOGY

Both secondary and primary research helped to answer and to get ideas and insights about the Research Question.

It is first important to remind the Research Question, as this will help on realizing which methodology and approach to use. The question is subjective, which means there is no correct answer and is dependent on a lot of variables. Debating whether the future of ESG Rating Agencies is bright or not in order to find the path to success, along with understanding their challenges for the future and possible solutions, means the research is qualitative, and thus needs qualitative methodologies.

### 3.1 Secondary Data

Firstly on Secondary Data, it obviously allowed to broaden the knowledge about ESG Rating Agencies and its market. And secondary data can be used in several different ways (Saunders, Lewis, & Thornhill, 2009). As this market is relatively new, I tried to gather as much information and get to know all the research done and subjects which had gotten already to a point of agreement. Literature review on journal articles was quite interesting to get to know opinions and insights and understand how they changed throughout time. Then, the latest reports from big associations in the sustainability field, such as the American Council for Capital Formation (ACCF), Principles of Responsible Investment (PRI) or SustainAbility were fundamental. Here, thoughts on the Best Practices, Challenges, Recommendations, and Future were gathered. Not only that, but understanding also deeply how Credit Rating Agencies work proved to also be essential in order to be able to shift to ESG Rating Agencies and analyze them properly. Moreover, I was able to get access to both qualitative and quantitative data through this research, as studies not only interviewed people in the field to get to know the general opinion, but also did surveys which then showed interesting statistics on the feelings of investors and other stakeholders towards this type of agencies and investment strategy.

## 3.2 Primary Data

Onto Primary Data, it was already agreed it would be Qualitative. Quantitative data would make little sense in this situation as there are no questions being asked with a clear yes or no type, as a lot of thinking and debate is needed around them. Then, the obvious approach is Interview, as this will allow for a conversation with the interviewee to get to know his opinions and way of thought (Creswell, 2012).

### 3.2.1 Sampling

The Sampling was done through the Purposeful Sampling approach (Creswell, 2012). It would never be the normal way of Sampling, Random Sampling, as there were clear targets on who to interview. Another reason for this is the fact that this market is quite specific, so only people inside it and directly involved with it would be able to have insightful and structured ideas and thoughts. The targets were thus people inside the main ESG Rating Agencies and their clients (investors), along with individuals inside Credit Rating Agencies who were part of the sustainability team of these.

### 3.2.2 Contact

The contact with these individuals revealed to be a big challenge, mostly for two reasons: time constraints and the number of desirable people to interview. Another issue was the announcement of the deal between Moody’s and Vigeo Eiris in the middle of the interview process (further explained in Chapter 4.1.4). This made companies less available to share ideas and thoughts on the theme, and some interviews were canceled last minute.

First contacts were made through LinkedIn and by contacting the HR services of each of the Rating Agencies. The initial list of companies to interview consisted of the following names:

- ESG Rating Agencies: Inrate, RobecoSAM, RepRisk, ISS, Vigeo Eiris, Sustainalytics, MSCI
- Credit Rating Agencies: Fitch, Standard & Poor's, Moody's

In the end, from these, six interviews were achieved with individuals from Inrate, RobecoSAM, ISS, Vigeo Eiris, Fitch and Standard & Poor's; plus one additional interview with an individual from the banking sector, to also hear the opinions of someone on the other side of the spectrum: on the side of the client and investor.

### 3.3.3 Interviews

In total, seven interviews were made. The interviews were mostly structured, as there was a clear objective with the interviews, although there was complete freedom to talk more about one specific topic or other, according to the interviewee will and comfortableness.

All questions were open-end type, with five main topics being discussed:

- *Current Situation of the Market* – Where the interviewee was asked about the current state and importance of the market of ESG Rating Agencies,
- *Best Practices* – Along with challenges and opportunities for ESGRAs,
- *ESG Rating Agencies* – For more specific questions about the Agency itself,

- *Credit Rating Agencies* – On how the relationships between the two types of Agencies were and how did each see the other side,
- *Future* – Through a possible future scenarios question.

Worth mentioning is that three different interview guides were made, in order to adapt to the company that the interviewee was from (ESG Rating Agency – Appendix I, Credit Rating Agency – Appendix II or Banking – Appendix III). The plans were sent to the interviewee before the interview.

Three of the interviews were done by e-mail, as it was preferred by the interviewees, mainly because of time constraints and availability. The other four were done by telephone. The interview process lasted from the 15th of April until the 2nd of May of 2019. The four telephone interviews had an average length of 40 minutes and were recorded. All transcripts for the seven interviews can be seen in the Appendices.

#### 3.3.4 Procedure

The procedure of the analysis will be done through the Narrative way (Creswell, 2012), where storytelling structures will be looked into. Each interview will be analyzed, one by one, company by company, finding the most relevant and important points made. Then, a comparison between the thoughts of the individuals of each of the Agencies will be done to understand what are the main areas agreed, and main areas where there is still disagreement and not so clear ideas, or possibility for every way of thought. The same will be done for the individuals from Credit Rating Agencies. The interview made to the individual from the banking sector will be used to support the debate on the several topics discussed throughout. This will lead to the current thoughts on the future of ESG Rating Agencies and their market, from people inside it and directly involved with it.

# 4. ANALYSIS

For the analysis, an introduction to each of the Agencies will be done before actually analyzing each of the interviews. This will be firstly done with ESG Rating Agencies and then with Credit Rating Agencies. The interview to the individual from the Banking Sector will be analyzed last.

## 4.1 ESG Rating Agencies

On ESG Rating Agencies, four individuals from four different agencies were interviewed: Inrate, RobecoSAM, ISS and Vigeo Eiris.

### 4.1.1 Inrate

Inrate is an independent Swiss company, based in Zurich with premises also in Geneva, composed by a team of around 50 people in Switzerland and India. It was created in 1990 with the name of Centre Info, aiming to promote sustainable development. In 2010, Centre Info merged with INrate to create Inrate AG, to then in 2015 acquire zRating (an independent shareholder services provider). The Agency is owned by Infras AG, the NEST Foundation and by members of the Board of Directors, while ensuring there are no conflicts of interest.

Its research universe is composed of 3200 titles, being continuously updated. These go from listed companies to issuers of bonds and governments. Ratings go from A+, attributed to a highly sustainable company, to D-, attributed to a not sustainable company (Schwegler, 2018).

The contact from Inrate is Antonius Knep and the interview was done by mail, with the answers being received on the 15th of April of 2019. While answering the questions, Antonius made it clear he was giving his personal view and not the company's one.

Antonius Knep is the Head of Research Operations at Inrate. In his role, he puts "the "Research" done on how to evaluate entities' ESG endeavors and performance into practice", meaning the database is filled according to the methodology. Moreover, he is also responsible for HR-related matters at Inrate.

Regarding the opinion on the current state of the market of ESG Rating Agencies, the big word mentioned was Consolidation, which is still going on, and according to the interviewee, this is not the best path for the market as it is inserted in the sustainability environment, which can have so many different definitions. There was an opposition to having few big firms all doing the same and the belief that when the market reaches its final state, big players will lose their competitive edge with everyone providing roughly the same things.

> "In my opinion, every serious investor should understand what she or he is buying with a given ESG rating and should receive several different ones in order to draw his or her own conclusion, reflecting respective values and beliefs."

On this matter, Antonius sees positively the fact that more regulatory pressure is coming into the market, plus clients want more transparency.

Then, when asked about who the services of ESG Rating Agencies are important to, three types of recipients were mentioned. Firstly, Institutional Investors, from pension funds to insurance companies, wealth managers, banks, PE investors…; then NGOs; and, finally, Individuals interested in how they should invest.

Going forward to the main objectives and functions of ESG Rating Agencies, the contact from Inrate suggested that better showing the risks and opportunities of investments from an ESG perspective is certainly one of them, and it is now being met up to a limited extent as the impact from such investments is still unclear. Then, helping the public to better interpret and understand the definitions around sustainability and ESG, plus being a provider of ratings and raw data on ESG. An additional function/objective was indicated: contributing to the redistribution of money flows, which is said to be met partially right now, as more investments, also from companies themselves, are being put into Sustainability.

The Best Practices were also an important part of the interview, and here Antonius proposed four elements that should be into final ratings:

1- Business Intrinsic Impact, or the actual impact that the product or service has;
2- Sector-specific ESG questions;
3- Controversies;
4- Product screening for incriminated activities.

Moreover, the rating methodology should also be explained in an easy to understand language, backed by everyday-life examples; along with being confident enough to sell also raw data and not only ratings. This is actually advised as one of the additional services that ESGRAs could focus on, to then point out that other services such as consulting and asset management should be avoided as there is the danger of these bringing biases into ratings.

As opportunities for these Agencies, international standards were firstly indicated, as their reputation and future adoption will attract more attention and increase the client base. Along with these lines, regulatory pressure, and especially being the first mover in understanding the regulator's movements and being prepared for their demands and incorporating them into the methodologies. Finally, the increased consumer awareness, not only for what was already said but also for the bigger interest in sustainability causes and natural and societal catastrophes. After this, the challenges were approached, and this, in the end, can be seen as opportunities as well, depending on how companies and agencies face them. On short-term challenges, the increasing coverage and number of KPIs being evaluated, along with data availability and comparability, and the automatization. On the long-term, language issues, which the Agencies already try to solve; market consolidation; and declining prices for the service were mentioned. To solve these challenges, the efforts already being put in place are the use of AI for data collection and analysis, the fostering of global standards and the adherence to those to achieve standardization, volume increases along with leverage on the research to overcome the declining prices, and the attempt to avoid an oligarchic market like the one in the world of Credit Rating Agencies, in order to prevent market distortions as for example in the sub-prime crisis.

Talking more specifically about Inrate, its main client is its main shareholder: a collective pension fund of Swiss SMEs, along with other pension funds and banks. Inrate rates the MSCI Developed Market companies, MSCI Emerging Market companies, the Swiss Market Index companies and Swiss Bond Index issuers, irrespective of their client's requests, although the service is also provided to other companies if requested. It was also suggested that a list of clients can be named that has been relying on the Agency's services for decades. In terms of differentiation from other ESG Rating Agencies, the first point was that the intrinsic impact of a business industry is closely assessed in the overall assessment grade, and not only what the company itself states. Other than that, Inrate has cross-sectoral comparability, meaning ratings of companies from different industries can be directly compared, and considers the impact of a product over its entire value chain. There is no relationship between Inrate and any Credit Rating Agency.

On these Agencies, the interviewee does not see them as either an opportunity or a threat, just a provider of different information; and on the other hand, thinks that Credit Rating Agencies see ESG Rating Agencies as an interesting opportunity to enhance their business.

Then, as a critic of an oligopoly market in the ESG Ratings world, Antonius does not believe ESG Rating Agencies will ever be as big as Credit Rating Agencies, also because sustainability needs diversity.

Finally, regarding the future, Antonius thoughts are as follows: it is highly probable that ESG Rating Agencies will be as important as Credit Rating Agencies, also because the smart investor already incorporates their input alongside the CRAs input. A scenario where ESGRAs slowly fall out of the market due to CRAs addition of ESG Rating Services has some likelihood, although not high; while ESG Rating Agencies being acquired by Credit Rating Agencies is seen as something highly probable.

#### 4.1.2 RobecoSAM

RobecoSAM was founded in 1995 under the name of SAM and is an investment specialist focused exclusively on Sustainability Investing. The Agency is based in Zurich, and it became a member of Robeco in 2006, after being acquired, to then be merged with Robeco Switzerland in 2010. The company was then renamed in 2013 to RobecoSAM.

It assesses 4500 companies around the world, from 60 different industries. It then gives each a Total Sustainability Score between 0-100, to then rank them against other companies in the same industry (RobecoSAM, 2018). Worth to say that RobecoSAM is different from the other ESG Rating Agencies, as pointed out during the interview: it is an Asset Manager company, and within the it there is the ESG Ratings Department.

At RobecoSAM, the contact was Isabelle Stauffer, with the interview being done by phone on the 18th of April of 2019. Isabelle is the Sustainability Operations Manager and she is also responsible for the whole controversy assessment. Isabelle has been in RobecoSAM for more than 4 years.

The interviewee thinks that the market of ESG Rating Agencies is growing and getting more interest from investors. Also, the demand to know which ESG criteria are financially material has proved to be a driver here. Isabelle goes on by saying that ESG Ratings are important for not only investors but also companies, as these want to show investors they are doing well in ESG.

> *"In the past, we were more like a niche market but now we see more and more the interest, also from Credit Rating Agencies, which are getting into the ESG Rating Business as investors are getting interested in this data and they are becoming more and more important."*

On the functions and objectives of ESGRAs, few remarks are made: help investors making an adequate decision on their investment by providing high-quality data on ESG topics, through transparency and a good methodology; help companies improve their sustainability by showing them the Best Practices; and knowing which ESG criteria are financially material. Isabelle suggests that some of these can also be seen as Best Practices, along with being comparable and making a good selection of all the data received from companies, to only select what is truly relevant for the rating.

Being already an Asset Manager, that was the first suggestion of additional services that ESG Rating Agencies should focus on, to then also indicate the use and sale of more data to companies, as ESGRAs have access to a lot of information, for example regarding the Best Practices in sustainability for each industry.

Talking about opportunities for ESGRAs, more collaboration between each Agency was mentioned, through the reasoning that more investors would be interested, and making data more widely available. Then on challenges, the lack of public reporting from companies on sustainability was the number one challenge, as it makes the whole process much more demanding. Reporting ESG topics through widely accepted standards is suggested to be the way to go. Moreover, the transparency of methodologies is referred as another challenge, and here agencies do not want to disclose them too much because the methodology is part of their intellectual properties, but investors need to understand the data and how the rating got there. A final challenge is to select what is relevant data and what is material or not. On efforts to overcome these, adjusting to the same standards is indicated, although problems can still resist:

> *"(…) but it is hard as there are companies and agencies that don't want to collaborate and share their methodologies."*

When talking about RobecoSAM, its clients were referred to be mainly asset managers, with ratings being done mostly to companies in the Belgian Sustainability Index, in collaboration with S&P. They also do rating by request, but for a fee, as then they cannot publish their work anywhere and so they need something in return. Their clients are reported to be happy with the service as a client line is open all year long for any questions, making the companies quite keen on providing information. Moreover, the agency has been receiving *"a lot of requests for data from potential customers."*. This helpline is one of the ways that the Agency tries to differentiate from others, thus through a close customer contact. Not only that, but the fact that the company is an Asset Manager makes them strong on analyzing Financial Materiality, and they try to relate this to ESG.

The next theme was Credit Rating Agencies, and Isabelle sees them as a long-term opportunity through them giving more importance to ESG, and as a short-term possible threat as it means more competition for ESGRAs. Through the other perspective, Isabelle believes CRAs look at ESGRAs with interest, especially for the robust methodology and data. The history and knowledge and expertise of ESGRAs on the field compared to CRAs is indicated as the main strength of ESGRAs.

> *"They can start to develop a methodology, but they will need 5 to 10 years to start putting it on the market, so the way to go is either partner with ESGRAs or buy them.*

> *(…) So, for sure CRAs are interested in the market of ESGRAs and they might be interested in creating an ESG Rating Department within the company, but it won't be the same and they won't be able to replicate it alone or in the short term."*

Isabelle is a believer that some kind of relationship will need to happen in the future between ESGRAs and CRAs, either through a partnership or through CRAs acquiring the ESGRAs. She adds also that investors want to integrate financial data with ESG, and *"the better and quicker Rating Agencies are able to integrate both services, the happier clients will be."*.

#### 4.1.3 ISS

ISS is the mother company of ISS-oekom, its ESG Research part. Iss-oekom was founded in 1993, in Germany, through the name of oekom research. It then became a member of the ISS family in 2018. ISS acquired in 2015 Ethix SRI Advisors and then built a strategic partnership with other ESG Rating Agency: RepRisk, to further expand their ESG Research. The mother company counts with a team of more than 1800 employees, spread across 13 countries.

Its universe covers 7000 Corporate and Sovereign issuers worldwide. The ratings go from A+/4.00, given to companies with an excellent performance on sustainability, to D-/1.00, which is given to companies with poor performance on sustainability (ISS-oekom, 2018).

The contact from ISS was Julia Haake. The interview was done by phone on the 19th of April of 2019. Julia joined oekom 8 years ago and she is the Global Head of Responsible Investment Sales. This is the part of the Sales Department of ISS where all ESG Product Specialists are regrouped.

About the current state of the market of ESG Rating Agencies, Julia thinks the market is quite dynamic nowadays, also due to its strong growth during the last 10-15 years. She adds that the growth followed the increase in interest for Sustainable Investment and the growth of this type of clients. Moreover, she talked also about the consolidation the market has gone through and the geographical movement towards the United States, as the American market is now very active in Sustainable Investment. These ratings are said to be important to Institutional Investors and Asset Managers, along with the companies being rated as these can get to know what to do to get better at sustainability and how their competitors are doing in the matter.

The interviewee progressed by saying that the main objective of ESGRAs is to deliver evaluation, data, and information on the ESG performance of companies to investors. She thinks that having a strong methodology, covering all reporting norms and standards, is key to succeeding in the market. Then, having a sector-specific rating structure is added as another driver, through the reasoning that each sector has its own difficulties and specific challenges. Not only that but being independent of the companies being rated, along with evaluating every single indicator to get a robust final rating, without assumptions, which Julia suggests some agencies do not do. On additional services for these agencies, two aspects are brought up: first, advisory services to investors, showing them portfolio options and pieces of advice to maintain a good sustainable investment strategy; second, not rate only listed asset classes, but also private ones, like equities and real estate, so going for different asset classes. Here Julia says doing so can be tricky, as there is no public information and there are a lot of products to choose from to rate, but investors are starting to demand this.

Talking about the opportunities for ESGRAs, the entrance of new clients into this market is reported as the main one, through convincing them which is the best ESGRA service, along with starting to rate other asset classes. On challenges, there is the competition to existing and the price competition, which is pressured by the actual ESGRAs and the clients, who always want lower prices. This brought another challenge, which was the stability of the business model, especially revenue-wise, as to increase the rating universe more workers will need to be hired, thus increasing costs while not increasing so much revenue. On longer-term challenges, the use of Artificial Intelligence and the adaptation to new regulations on ESG Rating Agencies were mentioned. Efforts on being the first movers for both are being done, and who adapts first will succeed.

When discussing more precisely ISS, their rating universe consists of the major stock market indices, but they do also ratings by request. Here, the change in the business model being done by Vigeo Eiris, through their new partnership with Moody’s, was brought up, as they are starting to be paid by issuers and not investors, following the model of CRAs. The reasons reported for client satisfaction are the same ones through which ISS tries to differentiate from other agencies: quality in the service provided with the sector-specific approach, along with a very close relationship with the client and fast answering to any question or demand from their side. The training of the analysts was also referred.

On Credit Rating Agencies, ISS is following very closely and welcomes their move into ESG aspects, especially from a societal perspective. Whether they will become a threat is not yet clear, but the move in the market from Moody’s might change this view.

> *“Still, with now Moody’s acquiring Vigeo Eiris is a different story and all of this might change if they have the correct resources to get the ESG Ratings along with their internationally recognized brand. Surely something we will have a closer look at now.”*

Julia states her belief that CRAs are also interested in ESGRAs, and adds that the business model of both is still quite different, and the brand recognition is a big advantage ESGRAs have, as the experience and knowledge in the market has a weight in the eyes of the general public. There is no relationship between ISS and any CRA.

Finally, about the future, Julia sees as possible that ESGRAs become as important and big as CRAs. Then, she also brings another view into the future: the possibility that CRAs fall out of the market due to ESGRAs starting to provide financial ratings, through the acquisition of smaller CRAs and then doing the integration as well as possible.

> *"(...) I think that in 10 years from now there will be a whole different market and we can be very well known. It's a very concentrated market with a strong growth so we'll see who gets the biggest share."*

#### 4.1.4 Vigeo Eiris

Vigeo Eiris is a ESG rating and research agency, based in France, near Paris. The Agency counts with a team of 240 people, spread over 11 offices around the world. It was born from the merger of two big players in their historical markets: Vigeo and Eiris. Eiris was founded in 1983, with Vigeo being created in 2002. The merge between the two was announced in 2015.

On April 15th, 2019, the acquisition of Vigeo Eiris by the Credit Rating Agency Moody's was announced. This is undoubtedly a significant mark in the market of ESG Rating Agencies. The deal was done through Moody's acquiring a majority stake in Vigeo Eiris, with the objective of improving Moody's promotion of Global Standards for ESG. It was also pointed out that Vigeo Eiris will continue to be headquartered in Paris, under its current brand (Moody's, 2019). The Global Head of Assessments at Moody's Investors Service said that the acquisition "(…) will contribute to the further development of leading ESG risk assessments, enabling the market to benefit from a global standard in assessing ESG considerations as part of their investment decisions.". Moreover, the President of Vigeo Eiris added "This acquisition reinforces the importance of ESG assessments to market participants", denoting an optimistic vision into the future.

Vigeo Eiris currently assesses 4800 issuers worldwide. It give ratings through the assessment of 38 criteria (Generic Model, customized to take into consideration sector specific issues and criteria materiality) on three pillars: leadership, implementation, and results. It has four levels of performance: first level means an advanced level of sustainability performance, with a value of 100-60, second level is robust from 59-50, third level is limited from 49-30 and, finally, the fourth level, with a value of 29-0, means a weak level of sustainability performance.

The interview of Vigeo Eiris was done with Elise Attal, by phone, on the 25th of April of 2019. Elise is the Institutional Manager and she has been in this position for three years, where the main responsibilities are academic partnerships, developing the network of stakeholders, and monitor institutional relationships in terms of regulatory laws.

Elise started by suggesting that the ESG Rating Agencies market is in a rapid change moment, immediately giving the example of the partnership between Vigeo Eiris and Moody’s Investor Services. The interest in the Sustainable Investing market is growing and, with this, companies in the sector are also growing. Moreover, it is also a maturing market, with more partnerships happening and more legislation. The services of these agencies are said to be important to the companies being rated in order for them to improve their ESG side, to the investors who want all data on ESG to better invest, and, lastly, to NGOs and trading unions and academics as the interest in sustainability is widespread already and anyone with interest in a company will benefit from a bigger transparency and disclosure of their information.

While discussing the main objectives and functions of ESGRAs, being an ESG Data Provider was mentioned as the core business, not only on collecting data but on analyzing it and giving a qualified opinion on it. Then, being an advisor to investors on Sustainable Investing practices to, in the end, accomplish the mission of contributing to more sustainable financial markets. To do this, Elise indicated that engagement with the companies in order to have in-depth data is necessary, to, in the end, have more up to date and extensive information on the companies performances. Controversy assessment was also mentioned, to evaluate whether the company has a lot of allegations or not and how it is trying to mitigate and respond to it. Elise also mentioned Vigeo Eiris certification to the ISO 9001 Certification[4], which was said to be quite exclusive regarding the competitors. On additional services and functions, Elise brought up the two Paying Models now possible for ESGRAs. Before, it was only the Investor Paying Model, where the investors pay for the data, but now a change is happening into the Issuer Paying Model, where the issuers request specific rating agencies to rate them, which Vigeo Eiris is starting to develop through the partnership with Moody's. Elise stated her belief that the market will move towards this new model.

The interview went onto the different challenges and opportunities for ESGRAs. As opportunities, Elise promptly referred partnerships with recognized CRAs, as they will permit the addition of financial services and the access to new types of markets. On challenges, competition was the first one mentioned, through the big consolidation the market has been going through, along with the appearance of investors trying to create their in-house methodologies to assess ESG. To overcome these, investment in R&D was stated to be crucial to better develop methodologies and improve ESG Assessment, along with having a strong client relationship, through which it should be easy to show the strengths of the service provided by ESGRAs to clients.

About Vigeo Eiris, Elise indicated that the company rates nowadays companies mainly on the request of investors, although they are developing the Issuer Paying Model. On customer satisfaction, Vigeo Eiris launched a customer survey last year (through the ISO 9001) where

[4] This is the international standard which sets the requirements for a Quality Management System (QMS). The aim of this standard is that organizations meet customer requirements by correctly delivering products and services. (ASQ, n.d.)

clients gave a grade of 8 out of 10 in terms of their services, and the company intends on having even more precise questions in the future, so they know their customers well. The engagement with companies to have in-depth data, the ISO certification, and the new partnership with Moody's were mentioned as the ways that Vigeo Eiris is using to differentiate from other ESGRAs.

And, obviously, Vigeo Eiris sees CRAs as an opportunity, otherwise the partnership would not have happened and, on the same lines, Elise thinks CRAs see ESGRAs as also an opportunity, in order to have access to their knowledge and methodologies, developed throughout the years.

On the future and possible future scenarios, Elise is a supporter of the view that to survive and excel in this market, partnerships are necessary. She says we are reaching a "Second Age", and agencies thinking of staying alone will have a hard time surviving in the future.

> *"We are basically reaching a Second Age for ESGRAs and ESG Assessment, which means basically that partnering with companies that have a higher weight in the market is the way to go to have a higher potential of development."*

## 4.2 Credit Rating Agencies

Going now forward to Credit Rating Agencies, individuals from two of the "Big Three Credit Rating Agencies", from each sustainability team, were interviewed: Fitch and Standard & Poor's.

### 4.2.1 Fitch

Fitch Group is a Global Leader in financial information services. Fitch Ratings, part of the Fitch Group, is a main player in the market of credit ratings, commentary and research. The Agency was founded in 1914 and is headquartered in New York, US.

Fitch is a signatory of the PRI since August 2018, having been one of the latest signatories to these Principles. It launched in January of 2019 a new integrated scoring system clearly showing how ESG factors impact individual credit rating decisions. The company added that its "ESG approach fills a market gap by publicly disclosing how an ESG issue directly affects a company's current credit rating." (Fitch, 2019).

At Fitch, the contact was Andrew Steel with the interview being done by mail and the answers being received on the 25th of April of 2019. He made it clear that he was giving his own personal opinions and not the formal views or opinions of Fitch Ratings. Andrew is the Global Head of Sustainable Finance at Fitch, where he is responsible for developing and implementing the company's sustainable finance strategy. In his team, analysts try to *"develop and implement ways in which to provide independent, insightful and rigorous analytical views and opinions on the credit impact of E, S and G risk factors on rating decisions."*.

While considering ESG Rating Agencies, Andrew's opinion is quite variable as he says methodologies are often unclear and results inconsistent. There is a lack of the scale and rigor present in traditional credit ratings, which makes it hard to compare the output of different ESG Rating Agencies. He adds that the market is unregulated but understands it, as it is still a quite recent one and in early-stage development. Looking from the other side, he believes ESGRAs look at CRAs as being slow and inflexible in their approach, plus they think the Issuer Paying Model utilized by CRAs has big potential for conflicts of interest. But here Andrew counter argues by saying that an Investor Paying Model can have just as much if not more potential for conflicts of interest, ending with the thought that the way each agency manages these issues is the most important.

> *"Real issue is how potential conflicts are recognized and managed within the organizations. ESG agencies are underestimating the risk issues here."*

Andrew goes on by saying that there is a clear role needed in the market to develop analysis around sustainability-related risks, with ESGRAs occupying this space well until now. However, he thinks investors want more detail and scale and would prefer this type of work done by the traditional CRAs.

On the biggest challenges when giving an ESG Rating, Andrew began by identifying the poorly defined timeframes for the views being offered, adding that mainly backward-looking analysis is done currently. Moreover, the parameters analyzed are not well-defined, which results in big variability concerning ESG Ratings and results. The fact that the disclosure of ESG data from companies is not consistently done is also a big drawback, and it is said here that *"investors are looking to the big traditional credit agencies to help sort this out."*.

Andrew then discussed Fitch's efforts on its ESG offering, by saying that Fitch is the only agency to offer a comprehensive integrated approach to displaying transparently how E, S and G risk factors impact their credit decisions to individual entities, and he goes on by stating that Fitch has already successfully differentiated from both ESGRAs and other CRAs through this integrated approach, including it in its credit ratings. This approach has been gaining substantial traction amongst investors. Fitch is also invested in ESG, through holding small minority stakes in two AI ESG data providers, as part of its venture capital arm and portfolio of tech investments.

Continuing on this matter, Andrew sees ESGRAs as potentially an opportunity, especially now that the market is seeing more disclosure from issuers and substantial consolidation: *"there may be opportunities for the big CRAs to integrate these niche providers"*. He then also talks about the possibility of big ESGRAs starting to develop their CRA activities, but he does not believe these can end up having much success.

> *"As CRAs are heavily regulated there will be issues for the ESG Agencies in trying to compete on traditional credit analysis (risk of regulation and associated costs)."*

Andrew then also says that not only regulation but scale and relevance are the main obstacles for ESGRAs to compete with CRAs, as there are huge costs (financial and time) involved to achieve a relevant state in terms of coverage and analytical capabilities. The interviewee thus does not believe in a future state of the market where ESG Rating Agencies are as important as Credit Rating Agencies, and has an easier time imagining ESGRAs falling out of the market due to CRAs adding ESG Ratings into their offerings, or CRAs simply acquiring ESGRAs. Moreover, an extra state is suggested:

> *"Consolidation results in two or more dominant ESG Rating Agencies which offer analysis that is complementary (different timeframes / different perspective to traditional CRAs.)"*

### 4.2.2 Standard & Poor's

Standard & Poor's Financial Services LLP (S&P) is an American financial services company, founded in 1860 and based in New York, US. S&P Global Ratings is the part of the group responsible for providing credit ratings, being one of the world's leaders. It operates in 128 countries with approximately 1500 credit analysts.

The Agency was one of the founding signatories of the PRI, back in May 2016. The group acquired Trucost in 2016, a UK environmental consulting firm and a specialist in carbon, environmental data and risk analysis, as a measure to better incorporate ESG risks into their assessments (PRI, 2017). Moreover, the company has been active in the field, as between 2015 and 2017 more than 1000 corporate ratings were reported where an environmental or social factor proved to be important in the rating analysis (S&P Global Ratings, 2019).

Elisabeth Burks was the contact at S&P. The interview was done on the 2nd of May of 2019, by phone. Elisabeth is part of the Sustainable Finance team at S&P, a team which works on ESG within the Credit Rating Area, provides opinions on ESG Valuations, and looks into sustainability issues in the market and across the various practices of S&P Ratings.

Elisabeth begins by stating that both issuers and investors have been asking S&P to provide opinions on ESG and, because of this, S&P has been moving more and more into ESG, through providing ESG Valuations and writing some ESG paragraphs in Credit Ratings. With this, CRAs are moving already to the space occupied by ESGRAs, and the interviewee leaves it as up to issuers and investors to decide who ends up controlling this space of the market in the future.

On ESG Ratings, Elisabeth makes a comparison with Credit Ratings, by saying that Credit Ratings have already decades of experience of data and methodology, while that is still lacking on ESG Ratings. Not only that, but definitions are still quite unclear and there are a lot of different words possible to use, along with different criteria used by ESGRAs on their own methodologies. Clarity is a big challenge in this market, along with understating what is material or not for companies in the ESG field.

One of the main advantages Isabelle stated that CRAs can have over ESGRAs in providing ESG Valuations is the knowledge in financial materiality that their analysts have. Moreover, their understating of business models, sectors, and global differences can help CRAs make a good link between ESG Factors and Corporate Financial Performance, which investors demand nowadays.

*"We publish the ESG factors linked to Corporate Financial Performance and so we feel that for those reasons we're able to offer a good ESG Valuation and assessment on ESG Factors, beyond credit because we are experts in providing financial benchmarks."*

There is no relationship between S&P and any ESGRA at the moment, but Isabelle added that if S&P feels like they can provide more value in the ESG field by going into the market, they can do so. In the end, she suggests that it will be the responsibility of the markets as a whole to decide what might happen in the future between ESGRAs and CRAs.

## 4.3 Banking Sector

Finally, an interview to someone inside a banking company was done, in order to have access to the opinions on this matter from the client, or the investor, side.

This was the only interview done anonymously, by mail, with the answers being received on the 30th of April of 2019. The interviewee is part of a company in the Banking Sector and works in the Governance Department, where his main focus is company engagement and voting. He clearly stated his thoughts were not on behalf of the company.

Although his company does not use the actual ratings, there is a relationship between the company and ESG Rating Agencies to know the disclosure of information regarding CDP (Carbon Disclosure Project) from companies. The interviewee thinks that ESGRAs are helpful for investors as they provide research on non-financial topics, and interest in these has been increasing. Furthermore, the fact that ESG risks can materialize into severe financial risks is another reason for this, with examples such as the Volkswagen emissions scandal being given. He adds that relying only on ratings is not a good option. One of the reasoning given for this is the low correlation between the ratings of different ESGRAs.

*“This is not necessarily “lacking”, as it may be indicative of independence of thought, but is evidence that ratings on their own likely cannot be relied upon.”*

The interviewee goes on by saying that he does not believe ESGRAs will ever have the dimension or importance of CRAs, as issuers need credit ratings and it will be extremely hard for any ESGRA to match their knowledge and expertise and coverage in credit ratings. Moreover, for ESGRAs to grow and be influential, the interviewee suggests that more consolidation is needed, as the market is still quite fragmented, plus they should focus on uncovering ESG risks that could have financial dimensions and be useful for large investors.

# 5. DISCUSSION

The Discussion will serve to gather all results and thoughts gotten throughout the interviews, and to compare them, looking for aspects where an agreement is achieved, to then find other fields where controversy and unclarity are still around. All this while comparing also with the Literature Review, to find trends and possibly new ways of thinking and perhaps new possibilities and ideas from the latest moves in the market of ESG Rating Agencies.

## 5.1 Current State of the Market

When talking about the current state of the market of ESG Rating Agencies, there was clear agreement on the fact that the market is growing nowadays, with even the same words coming up in several interviews. There is thus no doubt that the market is in a very dynamic state, from the great increase in awareness and demand from investors of data and opinions on ESG.

Another word that was used with high frequency was consolidation. Here everyone recognized that the market was still in a consolidation phase, although there was room for some different ideas on it. Andrew Steel, from Fitch, believes the market is still in an early-stage development, while Elise Attal, from Vigeo Eiris, suggests that the market is already in a "Second Age" state, where consolidations are happening at a very rapid pace and partnerships are needed and are already happening throughout the market. She also adds that this is the way to achieve success in this market, while Antonius Knep, from Inrate, argues that consolidation is not good for the market of ESGRAs. The reasoning behind this argument is that the sustainability environment can have so many different definitions and each investor should have several different ratings at his disposal so that he can make his own reflection and decision. Once only some big players are left in the market, they will lose their competitive edge and everyone will provide practically the same things, which for Antonius is not the best way route. Still, on this matter, the contact from the Banking Sector believes that for ESGRAs to be successful and influential, they need to consolidate, as nowadays the market is too fragmented.

It can thus be said with safety that the market is undergoing a consolidation phase, as competition goes bigger and bigger and agencies feel the urge to also be bigger and bigger. On whether this is a good thing or not, it is more unclear, which is also corroborated by Avetisyan & Hockerts (2017), as they say clients might benefit from stronger entities and a more standardized environment through consolidation, but the quality might be affected if in the end there is not enough competition in the market.

An extra point is done by Julia Haake, from ISS, by saying that there is a geographical movement on the market towards the United States, as this market is now very active in Sustainable Investment. This is no surprise as, through the GSIR 2018 Report, one can see that ESG Screening is the number one strategy in the United States, and it is the strategy with the highest growth across all different strategies during the past two years.

On who the services of ESGRAs are important to, there is a clear agreement that they are to institutional investors (who dominate the market according to the 2018 GSIR), asset managers, NGOs, academics, and, through the addition of Elise Attal from Vigeo Eiris, to anyone with interest in investing and in the company, as these will benefit from the disclosure on ESG performance of company. Moreover, it was unanimous that these ratings are also important to the actual rated companies, as they can get to know what to do to get better at ESG and how their peers are behaving in the matter.

## 5.2 Functions and Best Practices

When talking about functions and best practices for ESG Rating Agencies, there was not a big room for disagreements, as this is according to each ESGRA experience and mission, and each different answer will, in fact, be a positive addition to the full answer. Still there were several common points brought up.

To be a Data Provider of ESG was always talked about as the core role of ESGRAs, while showing the risks and opportunities of ESG and knowing what is financially material, to in the end help the investors on their decisions. An indirect, very interesting function, brought up by Antonius Knep from Inrate, is being a redistributor of money flows, as these agencies are bringing more attention to ESG and are making it so that investors go more towards Sustainable Investing.

Regarding Best Practices, having a strong and robust methodology was usually talked about, with also explaining it to the investor through an easy to understand language, as pointed out by Antonius Knep from Inrate. Having sector-specific questions and rating structures was also mentioned, especially by the contacts at Inrate and ISS, as each sector has their own risks and challenges and thus should be assessed through a specific manner, with the literature backing up this statement ( (Chatterji & Levine, 2006) and (ACCF, 2018)). Moreover, having a controversy assessment was referred as Best Practice by the contacts at both Inrate and Vigeo Eiris, to see the allegations that the company has and how it is handling them. Novethic Research (2013) also validated this.

Then, some more Best Practices were indicated, taking into account specific examples from the interviewed Agencies, which were also indicated as differentiating from other ESGRAs:

- Inrate: Industry Assessment in the Rating, through assessing the impact, challenges and risks specific to the industry that the company is in; Cross Sectoral Comparability so that ratings from companies in different industries can be easily compared; Assessing the product over its entire value chain.
- RobecoSAM: Good selection of the relevant data and what is financially material; Having a helpline to clients.
- ISS: Not using assumptions to evaluate any criteria; Good training of analysts.
- Vigeo Eiris: Strong engagement with companies to get in-depth data; Being certified by the ISO 9001, through which even Customer Satisfaction surveys are done.

## 5.3 Opportunities / Challenges

When talking about the opportunities and challenges that ESG Rating Agencies face, several interesting points were covered.

One of the main opportunities mentioned was being the first mover. First mover in terms of new standards and regulations, through being prepared to them and predicting the moves and thoughts of regulators; in terms of the increase in customer awareness and getting new customers entering the market, through convincing them that the services of a specific ESGRA are the best; and in terms of using Artificial Intelligence to assess data, with this last one being seen as a challenge at the same time. Then, Isabelle Stauffer, from RobecoSAM, suggests another opportunity, which can also be seen as challenge: collaboration between agencies. Through doing this, better methodologies will come up and they will be much more transparent to investors, but agencies also do not want to show their intellectual property like that. On this, Jim Hawley (2017) argues there is no easy way around the dilemma. Elise Attal, from Vigeo Eiris, refers partnerships with CRAs as another opportunity, through the reasoning that this enables ESGRAs to add financial services and access new markets.

Onto challenges, and first with the short-term ones, the weak or lack of public reporting from companies on ESG is a clear challenge for agencies, which is mentioned by the contacts at Inrate, RobecoSAM and Fitch, with the contact of Fitch adding that some investors expect CRAs to solve this problem due to their size and influence. This is mentioned in the SustainAbility 2019 Report. The lack of comparability, with different ratings and methodologies, was also another frequently mentioned challenge. Several studies in the literature review support this, such as the SustainAbility 2019 Report where comparability and consistency are seen as the top priority for the future of ESG Ratings by investors, or the study from Escrig-Olmedo, Muñoz-Torres, & Fernandez-Izquierdo (2010), where lack of standardization is reported. The contact from the Banking Sector goes on by remembering the low correlation between ESGRAs different ratings, which was confirmed by Wigglesworth (2018) at 0.32, while the correlation between S&P and Moody's was calculated at 0.9. Another challenge is brought up by Andrew Steel from Inrate and Elisabeth Burks from S&P: language issues. There is not enough clarity in some definitions and people in the field end up using too many terms for the same thing, plus their definitions are still unclear. A final, interesting challenge, is mentioned by Elise Attal from Vigeo Eiris, where she talks about investors starting to try to make in-house methodologies to assess companies' ESG performance, although she goes on by saying doing so is costly and difficult and will never have the same quality as from an ESGRA. Still, she says agencies must convince investors of this. Through its report *Ratings that don't rate* (ACCF, 2018), this is exactly corroborated.

In regard to the long-term challenges, competition is the big word here. The market of ESG Rating Agencies is indeed extremely competitive and nowadays there is a war for survival. Not only competition for survival, but price competition, as the market is experiencing a decline in prices, caused by both this competition between the ESGRAs and the actual clients, who always try to pressure the agencies into lower prices, as explained by Julia Haake from ISS. She also brought up another challenge, which is the stability of the business model, especially in terms of revenue, as if the agencies want to cover more issuers they will need more hirings, while revenue will not increase too much, being this backed up by Chatterji & Levine (2006), who say ESG proves to have a lot of costs attached. One last challenge by Isabelle Stauffer, from RobecoSAM, was for Agencies to select the relevant and material data from what they receive from companies, being this long-term due to the difficulty in making such distinction and time needed for research. A study of 2015 by Khan, Serafeim, & Yoon talked about this important fact.

## 5.4 What to do

After talking about the challenges, the efforts being done in order to overcome these were discussed.

Being the first mover always came up, with strong investments in R&D, as pointed out by Elise Attal, being crucial to be in a good position to do so. R&D of how to use Artificial Intelligence and how to tackle the new standards and regulations on ESG Rating Agencies, but also to improve methodologies and make them more robust, more transparent and more comparable. The contact from Vigeo Eiris mentioned building a strong client relationship as a solution to the rising challenge of investors building in-house methodologies, as communication is quite important in this matter. Then, to overcome the declining in the price of service, Antonius Knep from Inrate suggested that volume increase and leverage is the way to go, which is a vision not shared by Julia Haake, from ISS, as she stated that covering more issuers will not make revenue increase much, due to the fact that investors are the ones paying and not issuers.

This brings a point of unclarity encountered during the interviews. All ESGRAs reported they use the Investor Paying Model, where it is the investor paying for the services of the agencies, although the contact from Vigeo Eiris, after the partnership with Moody's, reported that they are already developing an Issuer Paying Model, where the issuers are the ones paying to be rated. This is the traditional model, used by Credit Rating Agencies. Elise stated her belief the market will start moving towards this model, and Andrew Steel, from Fitch, made some interesting remarks on conflicts of interest concerning both models. He stated that ESGRAs think the Issuer Paying Model has big potential for conflicts of interest, to then say the Investor Paying Model can also have just as much potential. He wrapped up by saying the way agencies handle this issue is key.

Continuing on additional services that ESGRAs could focus on, selling raw data seemed to be a common idea, as these agencies receive a lot of information that can be interesting to other companies and profit can be made out of it. Jim Hawley (2017) is a defender of this idea. Moreover, the interviewee from ISS mentioned that investors are starting to demand ratings from other asset classes and from private products, which can be tricky due to lack of public information but can also be a first mover opportunity. The fact that Real Estate is starting to be noticeable in the Sustainable Investments allocation (GSIR, 2018) confirms this idea. Another one, from the contact at the Banking Sector, is that ESG analysis can uncover ESG risks which can then have financial dimensions and thus be useful for large investors.

Another additional service, widely covered, was advisory and consulting services, along with being an asset manager, which brought some controversy throughout the interviews. Isabelle Stauffer, from RobecoSAM, is an obvious supporter of the asset manager idea, as her company is already an Asset Manager, with a ratings department inside, and she adds that this makes them strong on analyzing Financial Materiality, to then try and relate it to ESG, which is so important to investors as shown in the Report of SustainAbility (2019). The idea of being an advisor to investors is backed up by the contacts at both ISS and Vigeo Eiris, through showing investors portfolio options and how to maintain a good sustainable investment strategy, which help accomplishing the mission of contributing to more sustainable financial markets. On the other hand, Antonius Knep, from Inrate, argues that consulting and asset management services should be avoided by ESGRAs, as these contain the danger of bringing biases into ratings and so the true independence of the agencies is concerned, without extending much more on the topic.

### 5.5 Credit Rating Agencies

The way that ESG Rating Agencies look at Credit Rating Agencies differs from contact to contact. Antonius Knep, from Inrate, sees them as different from ESGRAs; Isabelle Stauffer, from RobecoSAM, sees CRAs as a threat in the short-term as they mean higher competition, and as an opportunity in the long-term as they are bringing in more attention and awareness into the market of Sustainable Investing; Julia Haake, from ISS, says it is unclear as they are following closely CRAs movements; and, finally, Elise Attal, from Vigeo Eiris, sees them as a clear opportunity, following the partnership between the company and Moody’s Investor Services. Andrew Steel, from Fitch, believes ESGRAs look at CRAs as being slow and inflexible. When asked about the other spectrum (how did they think CRAs looked into ESGRAs), the answer was consistent: they are interested and see them as an opportunity to have both their knowledge and methodologies. The contact from Fitch goes on by adding that once there is good consolidation in the market and more standardization, it might be a good time to buy a smaller player.

On how to differentiate from CRAs and vice versa, the experience and knowledge that ESGRAs have on the market are reported to be the greatest strengths relative to CRAs. The fact that the methodology is robust and already has some historical data are reported as having weight in the client's minds when thinking about which services to go for, which is defended by the contacts at RobecoSAM and ISS. On the other hand, the contact from both S&P suggested that their expertise on financial materiality and business models makes them more prepared to make the link between ESG factors and Corporate Financial Performance, which was already seen to be valued by investors. On this, the interviewee from Fitch described how they are differentiating from both ESGRAs and other CRAs: they have a Comprehensive Integrated Approach displaying transparently how E, S and G risk factors impact their credit decisions and ratings.

Another interesting point was that, regarding partnerships between CRAs and ESGRAs, the one between Vigeo Eiris and Moody's Investor Services was not the only one referred. Indeed, RobecoSAM provides ratings towards a Sustainability Index done jointly with S&P, and Fitch is invested in two AI ESG data providers, meaning there is already some movements in the market.

## 5.6 Future

In relation to the future of the market of ESG Rating Agencies (and its possible scenarios), some very interesting ideas were raised, and it was possible to pick one winner amongst all prospects.

Interviewees were given three concrete future scenarios for the market, with the possibility of also suggesting another scenario:

a. *ESG Rating Agencies are as important as Credit Rating Agencies* – Some unclarity on this scenario, as the contacts from Inrate and ISS believe it is possible, through the reasoning that the smart investor is already the input from ESGRAs alongside the one from CRAs. Neither of the other interviewees believes in this scenario, as ESGRAs thinking of staying alone will have a hard time surviving and it will be hard to get to a comparable size without partnerships.

b. *ESG Rating Agencies slowly fall out of the market due to Credit Rating Agencies addition of ESG Rating Services* – Only Andrew Steel, from Fitch, believes in a scenario like this, although Antonius Knep, from Inrate, also sees some likelihood. This lack of belief is mainly due to the already mentioned expertise and history and robust methodologies that ESGRAs have, which are hard to replicate.

c. *ESG Rating Agencies are acquired by Credit Rating Agencies* – The winner in this exercise. There was a consensus from the interviewees on stating that this is a probable scenario to the future. Even more after the partnership between Vigeo Eiris and Moody's Investor Services. Isabelle Stauffer, from RobecoSAM, suggests that some kind of relationship between ESGRAs and CRAs will be needed to survive in the market; Elise Attal, from Vigeo Eiris, states that the market is reaching a "Second Age", where partnerships with CRAs are needed to survive and excel; Elisabeth Burks, from S&P, also has an easy time imagining her company going into the market and making a move, if needed. This scenario is also sustained in the literature, through Schäfer (2005) and PRI's 2017 Report (Part 1).

d. *Other* – The scenario where CRAs fall out of the market because ESGRAs start having financial ratings in their offerings is brought up by the contacts at ISS and Fitch. The first one wants to believe it is possible, while the second explains that it is highly unlikely due to the scale needed to do so, along with the high regulations

> and costs in place to provide credit ratings. The contact from Fitch brings another scenario, in which he believes in, where the consolidation in the market of ESGRAs results in two or more big agencies, which will give complementary analysis to the one given by CRAs, through different timeframes and different perspectives. Escrig-Olmedo, Muñoz-Torres, & Fernandez-Izquierdo (2010) support this last scenario by saying that a process of mergers lead by the strongest agencies is expectable. The Report from PRI of 2017 even added an extra scenario, where small ESGRAs are spread over the world and specialize in specific industries, always trying to be innovative and stay ahead of the big players and remain meaningful.

Through the words of Elisabeth Stauffer, from S&P, the safe thing to say regarding the future of the market of ESG Rating Agencies is that it will be the responsibility of the markets as a whole to decide what might happen in the future. Still, through the results of this exercise, it is safe to say that the market of ESG Rating Agencies will experience more consolidation and partnerships, specifically with Credit Rating Agencies, and the path to success is exactly through these partnerships.

# 6. CONCLUSION

To conclude this dissertation, a wrap-up of the most important thoughts will be done, to then discuss the controversies found (and give some personal opinions), all while reflecting on the Research Focus and Objectives. The Contributions to Knowledge will then be explained, by showing why this research is important, to finally approach the Limitations of the Study and Recommendations for Future Research.

## 6.1 Research Objectives

Firstly, the Research Question will be remembered. It is a broad question, which tries to predict and assess the future of the market of ESG Rating Agencies, while also reflecting on their challenges and possible solutions, so what path to take in order to succeed in the future. Seven interviews were done to individuals directly involved in this market.

And, in the end, one can say with relative certainty that the future of ESGRAs is bright, although their success path is not to be done alone. There is an increasing interest in ESG and in this market, plus the interest from CRAs on it was also evident. ESGRAs are expected to be successful with the help of these entities, and the scenario where either partnerships or merges between ESGRAs and CRAs happen in the future was the most believed in one, also following the latest move in the market between Vigeo Eiris and Moody's Investor Services. Most of the interviewees mentioned the need for a partnership with CRAs in the future to survive and excel in the market. Also, due to ESGRAs' expertise, history, and robust methodology, they are seen as an opportunity by CRAs to enter in the market and the contact from Fitch even suggested that once the market is consolidated it might be a good time for an acquisition.

This brings up the clear thought that this is a market in a dynamic and growing state, along with the fact that it is consolidating. There were some critics on this, especially through the reasoning that the market needs competition, but the truth is, even in an oligopolistic market, competition will still exist. Moreover, once consolidation is achieved, there will be stronger entities and the market will be more standardized, as defended by Avetisyan & Hockerts (2017). Not only that, but once the market is consolidated, agencies will be able to focus on truly competing and not surviving, resulting in truly trying to improve the quality of the service and not just battling for the price.

One could find it interesting to know the market value of the ESG Rating Agencies market, but this is undoubtedly a hard figure to even predict, as the companies are private and do not disclose a lot of information, especially financial data. Vigeo Eiris and Moody’s not disclosing the financial part of their deal is just another example of this lack of data. The expected growth of this market is thus also difficult to evaluate, although for all the qualitative statements already mentioned, there is not much more to expect than progress.

Then, on Best Practices for ESGRAs, common ideas were drawn, which are also backed up by Literature, such as having a strong methodology with easy-to-understand language, a controversy assessment, a comparable rating through industries, a helpline to clients, among others. Two other ideas were discussed: first, sector/industry-specific rating structure, due to each sector own risks and challenges, and although this is somewhat referred in the Literature, it seems more importance should be given to it as it can change the quality and usefulness of ratings to investors, and not every contact from the ESGRAs talked about it, suggesting this can be one cause for the low correlation between ratings. Moreover, the second interesting idea was being certified by the ISO 9001, which only Vigeo Eiris mentioned and the interviewee from this agency also referred to it as being quite exclusive regarding the competitors, and can be seen as a big advantage towards other agencies, as it is a recognized quality stamp.

Being the first mover and being prepared to tackle the use of AI and new regulations was widely seen as a big opportunity, which can be achieved through investments in R&D. On challenges, lack of comparability, language issues and the weak public reporting on ESG seem to be the main ones, which matches the Literature. One might think that an oligopoly market might help solving all of these challenges, as with fewer, bigger companies, they will start providing similar results due to finally being standardized and understanding what is the best methodology, going also towards solving any language issues in the field. Then, bigger, more influential agencies, will have the power to demand more information to companies. Andrew Steel from Fitch added that investors count on CRAs to also help in this matter, which goes along with the idea that partnerships between both types of agencies are needed.

The other big challenge is competition and consequent declining in price. This brought another controversy: how to tackle this challenge. Some interviewees suggested that increasing the volume and leverage the number of issuers evaluated can be the solution, while others said this would not increase the revenue at a satisfactory level, due to the necessary costs of hiring more analysts. There was not indeed an agreement on this, where the introduction of another discussion is helpful: which paying model should ESGRAs follow. Nowadays, ESGRAs follow the Investor Paying Model, while the traditional model of Issuer Paying Model is used by CRAs, although Vigeo Eiris is developing already an Issuer Paying Model through the deal with Moody's. ESGRAs defend this model is propitious to conflicts of interest, but the interviewee from Fitch mentioned the Investor Paying Model has the same or even more potential to this type of issues. Citing his thoughts: "how potential conflicts are recognized and managed within the organizations" is crucial, and the fact is an Issuer Paying Model could solve the problem of declining price, as then increasing the volume would truly increase the revenue of a business model like this. Selling raw data was also mentioned as a potential extra source of income.

Two final thoughts for ESGRAs to achieve success were starting to rate other asset classes, which will give them a differentiation but can be tricky, as information will be hard to get; and providing advisory, consulting and asset management services. This was the last discord observed through this exercise. The contact from Inrate built a quite critical position on this addition, by saying they can bring bias into the ratings, while all the others did not see it with bad eyes. One can again say it will depend on how each organization handles the issue of independence.

## 6.2 Contributions to Knowledge

This research has contributed to better understand what lies ahead in the path of ESGRAs. Not a lot of studies tried to predict or reflect on the future states of the market of ESGRAs, also because it is not an easy task to do and a lot of variables come into play. Not only that, but most of the research done focuses on the current state and current challenges for ESGRAs, preferring to not make forward-looking reflections. But, especially after the move in the market from Vigeo Eiris and Moody's, it becomes apparent that the market is in a turning state and more studies on the possibilities are needed. Getting to know the opinions of people directly inside the market, along with from individuals on the CRA side and on the client (investor) side, certainly made a reliable spectrum to where to look for answers. Expressions such as "we are entering in the Second Age of the ESGRA market" were truly refreshing, and the fact that most of the interviewees believe that relationships between ESGRAs and CRAs are needed and will happen is a strong statement, which few studies touched before.

Then, due to the extensive part of this research, best practices, opportunities, challenges, and possible solutions were assessed and reflected, with some new ideas and thoughts coming up. Not only that, but this research made it possible to detect some controversial points where more reflection is needed to really understand what to do and how to act in the future.

### 6.3 Limitations of the Research

With the belief that this research contributed to the already existing literature in ESG and more specifically ESGRAs, it is certainly important to identify and understand any limitation present. These are described below.

The first consists of limitations regarding time and number of interviewees. Getting interviews with individuals from inside the market of ESGRAs proved to be a remarkable task, as there is not a lot of people inside each organization and, as this study made clear to infer, time is a lacking resource inside these organizations. Indeed, more time than expected was needed in order to end up with an acceptable number of interviews, which then left less time available for the next phases in the research. Moreover, contacts from important ESGRAs, such as MSCI and Sustainalytics were not possible to interview, despite all the efforts done.

Secondly, the deal between Vigeo Eiris and Moody's Investor Services happening exactly during the interviews period, which resulted in some canceled interviews due to higher levels of corporate confidentiality, plus caused the thoughts from the interviewees to change during this period. Also, the interviewee's bias, having some from ESGRAs and others from CRAs along the fact that all interviewees work in the world of ESG (pre-requisit in this research), can also be seen as a limitation.

Finally, Sustainability Indices were not discussed in this research. This was due to the fact that they were not the target of study, and even though they are offered by some ESGRAs in their services, it is still unclear how they are constructed and what methodologies they use, meaning a new dissertation could be done on this matter.

### 6.4 Recommendations and Further Research

On Recommendations, one of the limitations mentioned earlier can be seen as an opportunity for future studies, in the way that hearing the opinion of people inside other agencies not covered in this research could add new and additional thoughts to the matter. On the same note, analyzing the opinions of individuals more on the client side can prove to also be interesting, as in this research only one investor was interviewed. Also worth mentioning is the possibility of trying to predict and reflect on the path to success of Sustainability Indices.

Then, onto Further Research, the implications of a market where partnerships and mergers between CRAs and ESGRAs have already happened could be better analyzed and predicted. So, through this, trying to predict the "future of the future", as it might turn out to be quite useful for these agencies and other players to start already thinking and preparing for the after of this possible scenario.

This research found several controversial points around ESGRAs, and studies about them can surely be insightful for the success of these agencies. The first is whether consolidation in the market is the way to go, or if the market should try to avoid an oligopolistic situation, as defended by Antonius Knep from Inrate. Then, the pros and cons of a sector-specific rating structure should be better assessed, also to understand why not every agency uses them and to examine whether differences in ratings from ESGRAs can be attributed to this fact, as even studies done until now do not provide a clear view on this. Another study perspective is how to achieve collaboration between ESGRAs, as the benefits from doing so are clear, with the difficulty to achieve it also being clear, and, as Jim Hawley (2017) suggested, "there is no easy way around this problem", or is it?

Two final further studies can also prove to be worthwhile: the implications from ESGRAs following an Investor Paying Model vs an Issuer Paying Model, through investigating which one is best; and, aligned with this, whether ESGRAs can and should offer advisory and asset management services, connecting this thought with possible conflicts of interest issues.

Being this a recent field, there is obviously several further research to be done, and truth is each new study will be adding something meaningful to the literature, due to its relative subjectivity, meaning that as long as new ideas are well argued, they will prove to be interesting to the community. ESGRAs still have a long path to go, and I cherish this study made this path (to future success) somewhat brighter.

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# APPENDICES

## APPENDIX I – Interviews with ESG Rating Agencies

### Structure of the Interview

Opinion / Current Situation

1. What is your specific role in the organization? What are your main responsibilities and focus?
2. What is your opinion on the current state and position in the market of ESG Rating Agencies?
3. Who are they important to?

Functions / Best Practices

4. What do you think to be the main objectives and functions of ESG Rating Agencies? Do you think they are all being met right now?
5. What are, in your opinion, the Best Practices on giving ratings?
6. Are there any additional functions / services ESG Rating Agencies should focus on?
7. What would you mention as opportunities for ESG Rating Agencies and how to reach them?
8. Which would you say are the challenges for ESG Rating Agencies, in the short and long term? Are there any problems to be solved?
9. What efforts are already being put in place? What do you think to be the path to success (solutions) to overcome these challenges?

ESG Rating Agency

10. Who are your customers? Is your service based on request or you rate all companies? Are you specialized in some type of companies or features?
11. What is the opinion of your customers on you? Any evidence?
12. How do you differentiate from other ESG Rating Agencies? What would you say is your competitive advantage?

Credit Rating Agencies

13. Do you see Credit Rating Agencies as a problem/threat, or as an opportunity?
14. And how do you think Credit Rating Agencies look at ESG Rating Agencies?
15. Do you think you will ever have the dimension of Credit Rating Agencies?

16. How do you / will you differentiate from Credit Rating Agencies, now that they are investing in ESG screening?
17. Is there any kind of relationship between you and any Credit Rating Agency?

Future

18. Where do you see ESG Rating Agencies in the future? How probable would you say these situations are?
    a. ESG Rating Agencies are as important as Credit Rating Agencies
    b. ESG Rating Agencies slowly fall out of the market due to Credit Rating Agencies addition of ESG Rating Services
    c. ESG Rating Agencies are acquired by Credit Rating Agencies
    d. Other

**Interview Antonius Knep, Head of Research Operations at Inrate**

(done by mail on the 15th of April of 2019)

Opinion / Current Situation

1. What is your specific role in the organization? What are your main responsibilities and focus?

**A:** I am working as "Head Research Operations" at Inrate. It is my task to put the "Research" done on how to evaluate entities' ESG endeavors and performance into practice, i.e. to fill the data base according to our methodology. To this end, I am working with 8 colleagues in Zurich (5.8 FTEs, "analysts") and 22 colleagues in India ("researchers"). Important to note: Our Research Operations Team is closely linked to the internal multi-disciplinary Research Team because, first, academic knowledge is to be challenged by practicability, and second, we are not mere "people filling data bases by collecting data" but experts in sustainability with a huge variety of sector expertise.

In addition, as part of the management board of Inrate, I am in charge of HR-related matters at our company.

2. What is your opinion on the current state and position in the market of ESG Rating Agencies?

**A:** Current state: Consolidation is still going on – size does matter. I am critical against this trend: If everyone is doing the same, how can we explain such an important and differentiated topic like "sustainability" that can have so many different definitions. In my opinion, every serious investor should understand what she or he is buying with a given ESG rating and should receive several different ones in order to draw his or her own conclusion, reflecting respective values and beliefs.

Market of ESG: The market is doing better and better because regulatory pressure is increasing and most likely is to increase even more going forward – many investors try to be ahead of the curve and try to prevent unpleasant situations in which they are "chased" by the regulator. In addition, end-clients demand more and more transparency. After many consumers began to ask "How can this t-shirt be so cheap? Where does it come from? Under what conditions has it been produced?" an increasing number of people now starts to ask "What are institutional investors doing with my pension contributions / insurance premia / etc.?"

Position in the market of ESG: Again, size does matter, especially coverage and variety of products and services. The bigger companies will do better, however, they will most likely lose their competitive edge when eventually everyone is providing more or less the same information based on corporation's CSR reporting and corresponding adjustments due to controversies/issues. Hardly any of the big players is neutral – many issue indices, manage money or belong to rating agencies. The amount of people questioning these activities might increase.

3. Who are they important to?

**A:** Institutional investors (pension funds, insurance companies, wealth managers, banks, PE investors, municipalities, regions, states)

NGOs (Example: Red Cross of course not interested in having child labor issues-companies in its investment portfolio)

Individuals interested in how they invest

<u>Functions / Best Practices</u>

4. What do you think to be the main objectives and functions of ESG Rating Agencies? Do you think they are all being met right now?

**A:** Main objectives and functions:

a. Providing additional insights into risks and opportunities of investments from an ESG perspective > Right now met to a limited extend – "impact" is not yet clear in most cases.

b. Providing different interpretations/definitions of "sustainability"/"impact"/"ESG"/etc. > Right now met to a limited extent – in future this objective might get lost completely.

c. Providing ratings and raw data (that might in turn f.i. used by institutional investors for an integrative approach to investments > Right now met.

d. Contributing to the re-distribution of money flows > Right now maybe met partially, who knows?

5. What are, in your opinion, the Best Practices on giving ratings?

**A:** Incorporation of four elements into final ratings:

a. Business intrinsic impact, i.e. the impact a certain product or service does come attached with > This is the answer to the question "What does this entity do?" > Because: No matter how good British Petrol, for example, is fostering women in management positions, this company is still drilling for oil.

b. Sector-specific set of ESG/CSR questions

c. Controversies/issues

d. Product screening for incriminated activities

Being able to explain the rating methodology in easy-to-understand language backed by everyday-life examples

Being good and confident enough not to sell only ratings but also raw data

6. Are there any additional functions / services ESG Rating Agencies should focus on?

**A:** Selling raw data > clients asking for these are clients able to ask the "nasty questions" that eventually lead to improvement of methodology, products and services

Keep distance from consulting, index providing, asset management, financial rating provision and all other activities that might bring biases into the ratings/raw data.

7. What would you mention as opportunities for ESG Rating Agencies and how to reach them?

**A:**

a. International standards and their reputation > The better the SDGs f.i. are understood and adopted (although they are designed to measure sustainability issues on government/state level) the more sense makes the mapping of existing rating methodologies for stock-listed and bond emitting entities (including states) to these standards. This will attract attention and might increase the client base.

b. Regulatory pressure > Analyze and understand regulator's movements and anticipate/incorporate them into the rating methodology – provide clients with transparency on these issues, i.e. on "compliance" with rules and regulations when investing in the companies/bond issuers etc. rated. (The same holds true for point a. mentioned above)

c. Increased consumer awareness > good marketing, increased use of lively examples and – very sorry to mention – natural and or societal catastrophes.

d. Challenges mentioned below under 8. might be opportunities as well – those ahead of the pack regarding the respective topics mentioned might do better.

8. Which would you say are the challenges for ESG Rating Agencies, in the short and long term? Are there any problems to be solved?

**A:**

a. Short-term challenges

    i. Increasing coverage > might get solved

    ii. Increasing number of KPIs evaluated/provided > might get solved

    iii. Data availability > might not get solved any time soon

    iv. Data comparability > might not get solved any time soon

    v. Automatization > might get solved

b. Long-term challenges

i. Market consolidation > not a question about "solving" or not

ii. Language issues > might get solved

iii. Declining prices > not a question about "solving" or not

9. What efforts are already being put in place? What do you think to be the path to success (solutions) to overcome these challenges?

**A:**

a. Automatization of data collection/analysis > AI

b. Standardization > Solution: Fostering global (reporting / certification / etc.) standards and the adherence to those

c. Declining prizes > volume increases / leverage of research

d. Market consolidation > make sure that the likelihood to experience unpleasant surprises are minimized by not allowing oligarchic structures like in the financial ratings space

<u>ESG Rating Agency</u>

10. Who are your customers? Is your service based on request or you rate all companies? Are you specialized in some type of companies or features?

**A:**

a. Customers: Main shareholder is main customer, i.e. a collective pension fund ("Sammelstiftung") of Swiss SMEs. Besides this, other pensions funds, banks (Raiffeisen Switzerland is biggest client with own fund palette "Futura" based exclusively on our input, asset managers, family offices, insurance companies and NGOs.

b. Rating: We rate the MSCI Developed Market companies, MSCI Emerging Market companies, the Swiss Market Index companies and Swiss Bond Index issuers irrespective of our client's requests. However, upon request we might include additional companies/issuers.

c. We are not specialized in any type of company but in a feature, i.e. the assessment of the respective business activity of a company. Accordingly, we are not only scrutinizing how the company is managing its operations from an ESG perspective and what kind of controversial activities might exist but also what, for instance, the intrinsic impact of car manufacturing on environment and society is.

11. What is the opinion of your customers on you? Any evidence?

**A:** Better ask our customers.

Evidence? In terms of retention we can name a row of clients that rely on our services since decades. One client's entire fund product range is solely based on our input and services. In addition, we have clients that expand the product and service bandwidth they procure from us.

12. How do you differentiate from other ESG Rating Agencies? What would you say is your competitive advantage?

**A:**

a. Consequent consideration of the intrinsic impact of a business activity, i.e the product's and service's intrinsic impact, in the overall assessment grade. NOT only CSR and controversies/issues. ("An oil driller is primarily drilling for oil, irrespective of how good it is separating its waste")

b. Consequent consideration of the impact of a product over the entire value chain: sourcing, production, use phase, end of life.

c. Cross sectoral comparability: A "B+" for a pharma company, for example, has the same positive overall impact as a "B+" for a software company.

<u>Credit Rating Agencies</u>

13. Do you see Credit Rating Agencies as a problem/threat, or as an opportunity?

**A:** Neither as problem/threat nor as an opportunity. They provide something different: Financial Ratings, i.e. an assessment of the likelihood of default. We provide: Additional insights into risks and opportunities from an ESG perspective.

14. And how do you think Credit Rating Agencies look at ESG Rating Agencies?

**A:** As an interesting opportunity to enhance their business. However: Smart clients will ask about their integrity / unbiasedness.

15. Do you think you will ever have the dimension of Credit Rating Agencies?

**A:** No, I don’t think so. It would not be advisable to become so big because “sustainability” per se needs diversity. Hence, conformity, oligopoly etc. is counterproductive.

16. How do you / will you differentiate from Credit Rating Agencies, now that they are investing in ESG screening?

**A:** See 13 and 12 above.

17. Is there any kind of relationship between you and any Credit Rating Agency?

**A:** No, as indicated above.

Future

18. Where do you see ESG Rating Agencies in the future? How probable would you say these situations are?

    a. ESG Rating Agencies are as important as Credit Rating Agencies

       **A:** Yes, highly probable. The smart investor already incorporates their input alongside the Credit Rating Agencies’ input.

    b. ESG Rating Agencies slowly fall out of the market due to Credit Rating Agencies addition of ESG Rating Services

       **A:** Likelihood given, yes, but not necessarily high.

    c. ESG Rating Agencies are acquired by Credit Rating Agencies

       **A:** Yes, highly probable.

    d. Other

**Interview Isabelle Stauffer, Sustainability Operations Manager at RobecoSAM**

(done by phone on the 18th of April of 2019)

Opinion / Current Situation

1. What is your specific role in the organization? What are your main responsibilities and focus?

**A:** First, I just want to make a quick introduction to RobecoSAM: we are a bit different from other ESG Rating Agencies as we are also an Asset Manager Company and within the company, we have an ESG Ratings Department where we do ratings. We get our revenues mainly from our Asset Management business.

About myself, I am working in the ESG Rating Team and I am Sustainability Operations Manager at RobecoSAM. This part of the company does the ratings for other companies and for the Dow Jones Sustainability Index. In my team, we each have a responsibility for a specific industry plus I am responsible for the whole controversy assessment and my industries are banking, insurance and derived financials. I have been working in RobecoSAM for more than 4 years now.

2. What is your opinion on the current state and position in the market of ESG Rating Agencies?

**A:** I think that the market is clearly growing and we're getting more and more interest from investors. In the past, we were more like a niche market but now we see more and more the interest, also from Credit Rating Agencies which are getting into the ESG Rating Business as investors are getting interested in this data and they are becoming more and more important. So I think that the position will grow because people care more and more and have the need for more data and understanding which are the ESG criteria which are financially material.

3. Who are they important to?

**A:** They are very important for investors and clearly for companies because they want to show investors that they are doing well in ESG and that they are sustainable, and ESG Rating Agencies are of very good help for companies to get better and better at ESG topics, as nowadays there is big competition to be the best in class.

Functions / Best Practices

4. What do you think to be the main objectives and functions of ESG Rating Agencies? Do you think they are all being met right now?

**A:** I would say the main objectives of ESGRAs are to differentiate companies to investors and thus to provide high-quality data on ESG topics to help them make their decision on the investment. So here what is really important is the quality of the data (especially qualitative, although both are important) and the transparency and the methodology to really understand why one company is better rated than the other one. For companies, another role of ESGRAs is to make them more sustainable, show what are the Best Practices according to the leaders and drive their sustainable part forward. Finally, Financial Materiality is key, so to make sure that any ESG criteria topic that we are looking at is also financially material so that we can link it to the long-term financial performance of the company.

5. What are, in your opinion, the Best Practices on giving ratings?

**A:** Here, after already having talked about finding Financial Materiality on the ESG topics, comparability and clarity in the data provided are also very important, and so the alignment with standards such as the GRI. This is very important when we look at the investor perspective. Then it is also important to leverage all the data that we receive from the companies and select the most relevant to in the end show what are the Best Practices in companies.

6. Are there any additional functions / services ESG Rating Agencies should focus on?

**A:** Apart from Asset Management, which RobecoSAM is already very focused on, ESG Rating Agencies have access to a lot of data and they have access to what is Best Practices in a lot of different topics, so provide more information to companies or even engage with them to show them what we and the investor consider the Best Practice and then say that they should go in this direction. Here, getting a source of income would be obviously the way to go as it requires a bit more work and you are providing more information to companies.

7. What would you mention as opportunities for ESG Rating Agencies and how to reach them?

**A:** On opportunities, I would say there can be a mix between opportunities and challenges, but more collaboration between ESG Rating Agencies is definitely an opportunity to get more investors interested, and making data more widely available, especially looking into the long term.

8. Which would you say are the challenges for ESG Rating Agencies, in the short and long term? Are there any problems to be solved?

**A:** One of the challenges is the lack of public reporting from companies on ESG topics, so this is something that is quite challenging because we can only access companies based on public information, which means that the less the company reports the worse the rating will be. And this doesn't necessarily mean the company is bad, it can just mean that the company doesn't report their data in the way that we expect them to do. So, bringing companies together to report more and in a more standardized way is a challenge, and here work together with the industry is the way to go plus the alignment with the existing reporting standards. The more reports are standard, the easier it is for ESGRAs to get information that is comparable and provide better ratings. Another challenge is the transparency of the methodology, and here it is hard as on one side we don't want to disclose too much of our methodology and intellectual property to other agencies, but on the other side investors need to understand the data and to make a better-informed decision and to know why they should follow this or that ESGRA. Then the next challenge is trying to reduce the amount of data and only focus on the important data as people have less and less time to look at them so finding the data that is relevant and defining well the materiality is a big challenge.

9. What efforts are already being put in place? What do you think to be the path to success (solutions) to overcome these challenges?

**A:** Having more people and companies adjusting to the same standards, but it is hard as there are companies and agencies that don't want to collaborate and share their methodologies, but this is the way to go and to make efforts. There are already some events held where ESGRAs are invited to talk about and share their knowledge and methodologies and insights.

<u>ESG Rating Agency</u>

10. Who are your customers? Is your service based on request or you rate all companies? Are you specialized in some type of companies or features?

**A:** Most of our clients are Asset Managers and most of the ratings that we do are for the Belgian Sustainability Index, which is done in collaboration with S&P. We share clients with S&P which are mostly institutional investors. If a company requests specifically a rating, apart from the list of companies that we have to access based on S&P Indices, they can do so but it is not for free as we assess the company and provide feedback on different topics (what their score is, their ranking in the industry…). Also, as this service would only be for the company and we can't publish it anywhere not even for investors, it is a service where we don't get anything in return so it can't be for free.

11. What is the opinion of your customers on you? Any evidence?

**A:** On the company side, clients are happy as we have a client line that is open all year long for any questions that the companies might have about the content of the questionnaires and what we want to know about them, which makes these companies quite keen on providing us information. On the investors side, we can't say how happy our clients are but what we see is an increasing interest in ESG, not only the score but also the underlined data of the score. Actually, we have been receiving a lot of requests for data from potential customers.

12. How do you differentiate from other ESG Rating Agencies? What would you say is your competitive advantage?

**A:** The helpline I talked about already is definitely a point, along with the close contact we keep with our customers. Another point is the fact that we are an Asset Manager and so we focus a lot on ESG Criteria that are Financially Material, so we do have Materiality Analysis. We have 60 different industries along with a big Research Team which focuses on finding the ESG Criteria which have the highest impact on the Financial Performance of companies and I would say this is one of our main advantages compared to other ESGRAs which look into all ESG Criteria in general and focus maybe a bit less on Financial Materiality.

Credit Rating Agencies

13. Do you see Credit Rating Agencies as a problem/threat, or as an opportunity?

**A:** I would say in the long term as an opportunity as they are giving more importance to ESG in general, but in the short term, of course, it can be a threat because it means more competition to ESGRAs. As we see today, Credit Rating Agencies are interested in having ESG Rating

Services but the methodology that ESGRAs have developed is quite complex and needs a lot of research and many CRAs realize that they don't have the knowledge and the resources in their company to develop such business. So, this is good as they can't copy us, and in the end they need us to provide such ratings.

14. And how do you think Credit Rating Agencies look at ESG Rating Agencies?

**A:** They really think ESGRAs are interesting, and they want to go on that business, but they don't have the methodology or the people. They can start to develop a methodology, but they will need 5 to 10 years to start putting it on the market, so the way to go is either partner with ESGRAs or buy them. What is also important for investors is to look at historical data, so with a methodology like ours which has already 20 years of that and is something that you just can't build out of anywhere. So, for sure CRAs are interested in the market of ESGRAs and they might be interested in creating an ESG Rating Department within the company, but it won't be the same and they won't be able to replicate it alone or in the short term.

15. Do you think you will ever have the dimension of Credit Rating Agencies?

**A:** I don't really think so, the big CRAs might even have a part of their business then focused on ESG Ratings or they might partner with other ESGRAs, but I don't see ESGRAs becoming that big on their own.

16. How do you / will you differentiate from Credit Rating Agencies, now that they are investing in ESG screening?

**A:** As I said the experience and the years of data that we have compared to CRAs in the field, and I would also focus on the type of data: CRAs mostly sell rating based on numerical data, and people that would be interested in ESG Rating Services really want to understand the underlining data, they don't want to just know if someone is sustainable or not, they really want to understand who to choose according to their will in the Sustainable World.

17. Is there any kind of relationship between you and any Credit Rating Agency?

**A:** Yes, we partnered with S&P for the Belgian Sustainability Index, so we provide all the research and rating of companies that are used to derive this Index and so our Rating Department works very closely with S&P.

<u>Future</u>

18. Where do you see ESG Rating Agencies in the future? How probable would you say these situations are?
    a. ESG Rating Agencies are as important as Credit Rating Agencies
    b. ESG Rating Agencies slowly fall out of the market due to Credit Rating Agencies addition of ESG Rating Services
    c. ESG Rating Agencies are acquired by Credit Rating Agencies
    d. Other

**A:** Here I would say that the most probable scenario would be both ESG Rating Agencies being acquired by Credit Rating Agencies, and a partnership between the two happening. I think integration will be necessary in the future, so two options on C. I don't see option B, so this one I would exclude, and the same for option A. Still on C, investors are more and more interested in integrating in some way ESG, or only E or only S or only G in their investment, and they want to integrate that to the financial data that they usually use. So, the better and quicker Rating Agencies are able to integrate both services, the happier clients will be.

**Interview Julia Haake, Head of Sales Department at ISS**

(done by phone on the 19th of April of 2019)

Opinion / Current Situation

1. What is your specific role in the organization? What are your main responsibilities and focus?

**A:** I joined Oekom research almost 8 years ago and we were acquired by ISS last year, so now I'm part of that largest organization based in Paris. Talking about my role, we have a Sales Department at ISS with around 50 people, and there's one part of that Sales Department that regroups all our ESG Product Specialists and I am Head of that Team. My team members are based in different countries all over the world and they sell our ESG Products and Ratings to Institutional Investors such as Asset Managers.

2. What is your opinion on the current state and position in the market of ESG Rating Agencies?

**A:** There's a lot of strong dynamic in the market and the market of ESGRAs has been growing strongly for the last 10-15 years, which is a very good thing as we see that finance is turning more into sustainable development and responsible investment. Our situation has gone from a niche investment inside finance, and ESGRAs were also very niche and small only on a local level, but this has changed in the last years as our clients become bigger and Responsible Investment turns mainstream. All of this culminates in a strong growth also in the size of ESGRAs and in the consolidation of the market with smaller companies joining bigger ones, and also bigger companies joining even bigger ones. The market has been also moving into the United States, as the American market is really active now on Responsible Investment. This was also the reason we (Oekom) joined ISS last year as we were too small already for the market and we needed to join forces, and also the same case for Vigeo Eiris, which joined forces 3 years ago and now they were acquired by Moody's.

3. Who are they important to?

**A:** Apart from Institutional Investors and Asset Manager, they are also very important to Rated Companies and we see that companies are more and more interested in the results of their ratings. Of course, because they also see that Responsible Investment is becoming mainstream and investors are asking more and more for their scores. Moreover, this serves for them to understand what they can do to get better at their sustainability and to see how their competitors are doing and what their ratings are.

Functions / Best Practices

4. What do you think to be the main objectives and functions of ESG Rating Agencies? Do you think they are all being met right now?

**A:** The main objectives and functions are to deliver evaluation, data, and information on the ESG performance of companies to investors and that's what our clients pay us for.

5. What are, in your opinion, the Best Practices on giving ratings?

**A:** It is very important to have a strong Methodology that answers all the international reporting norms and standards such as GRI and more and I think all ESGRAs do that today. Then what we do and what is very appreciated by our clients is we don't apply the same rating methodology and structure to all companies because the sustainability challenges are different for each industry and many times not comparable at all. We have developed a sector-specific rating structure for over 60 different sectors and that allows us to be very close to the day to day reality and be very close to the different challenges of the different sectors. Then being independent from the companies that we rate is very important, which holds on the basic business model of ESGRAs which is being paid for by investors and not by the rated companies like is the case for CRAs. Vigeo Eiris is already changing their business model to be more like CRAs and thus be paid by issuers and not by investors. A final important aspect is that we actually rate all companies in our rating universe on every single indicator, and I know that some ESGRAs, for smaller companies, they just make assumptions or take sector averages for certain indicators and then get scores that have nothing to do with the day to day reality of the company because the research hasn't been done.

6. Are there any additional functions / services ESG Rating Agencies should focus on?

**A:** Sometimes we give advisory services to investors so they can know for example what their portfolio would look like if they were to include less licit producers and what would be our advice to maintain a good responsible investment strategy. Another thing that we are more and more asked by our investors and clients is to rate not only companies that are either listed in the stock market or bond issuers, but also private companies like private equities or companies or real estate and so different asset classes, which is something a bit more tricky from our perspective as there's a cost to rate the company and the more companies to rate the more people you need to rate, then the information is not public and there is a lot of companies and products to choose from to go for and actually rate them.

7. What would you mention as opportunities for ESG Rating Agencies and how to reach them?

**A:** A big opportunity is to follow the market evolution very closely and always be on the lookout for new potential clients entering the market and even convincing clients from other ESGRAs that our services are better and have more quality, and is something that we do on a day to day basis. Then there's the Index Business where we think there's a lot to do especially for more passive investors. Finally, Private Equity and other asset classes as I talked earlier are also very interesting to go for and started giving ratings.

8. Which would you say are the challenges for ESG Rating Agencies, in the short and long term? Are there any problems to be solved?

**A:** The challenges for us in the short term is that the market is very competitive and another clear challenge is the price of ESG Ratings because on one hand competitors can try to lower their price and then we have to adapt and then Asset Managers also have a lot of pressure on the price and can try to bring it down. With this, another challenge is the stability of our business model especially in terms of revenue, as if we want to increase our universe we have to hire more people and thus increase the costs with the revenue not growing that much. Then more on the long term one of the challenges will be definitely to see how we can use Artificial Intelligence in order to make the whole rating process a bit more efficient and then we'll see what the European Commission comes up with regarding regulations for ESG Ratings because we know that they are looking into that and thinking about that, so whatever comes up from them in the future can be a challenge to adapt to.

9. What efforts are already being put in place? What do you think to be the path to success (solutions) to overcome these challenges?

**A:** We are working pretty intensely on AI, as everybody does, and we'll see who comes up first with developments on it, but it is not straightforward what we can do with them. Surely it can be seen as an opportunity for first movers.

<u>ESG Rating Agency</u>

10. Who are your customers? Is your service based on request or you rate all companies? Are you specialized in some type of companies or features?

**A:** Our rating universe is about 5000 companies rated, from the major stock market indices (in Europe Stoxx 600 or in the US the S&P500 or Russel1000) so that's one of the principles to define our universe but then we have some clients that need specific market coverage that ask us to integrate specific issuers to our universe. Sometimes we do requested ratings, but they are very rare and what we don't do is requested audits to documents that the company issues related to Sustainability.

11. What is the opinion of your customers on you? Any evidence?

**A:** Our customers have two aspects that they definitely appreciate, the first one is the quality of our service and research and our sector-specific approach that we deliver, and the second aspect is that we are very close to our client and very fast in terms of delivering any answer to questions or problems that our clients might have.

12. How do you differentiate from other ESG Rating Agencies? What would you say is your competitive advantage?

**A:** Here I would say especially the two things that I already talked about which are our sector-specific approach and our close contact to the client, and then I would also add the level of training of our analysts is very important as we spend a lot of time training our analysts and they really get very in-depth information and training, plus they stay more time on board than average so they have good loyalty.

Credit Rating Agencies

13. Do you see Credit Rating Agencies as a problem/threat, or as an opportunity?

**A:** Right now, we are following very closely what they are doing and that's definitely something very interesting for us to see that they are moving towards ESG aspects, so from a societal perspective is something very good. Frankly, I don't know if they will become a threat because they sell mainly to issuers and not to investors, although they have some offering to investors but not on a big level. Still, with now Moody's acquiring Vigeo Eiris is a different story and all of this might change if they have the correct resources to get the ESG Ratings along with their internationally recognized brand. Surely something we will have a closer look at now.

14. And how do you think Credit Rating Agencies look at ESG Rating Agencies?

**A:** They are definitely interested in what we are doing, S&P bought Trucost and now Moody's. But I don't really know what their opinion on us is.

15. Do you think you will ever have the dimension of Credit Rating Agencies?

**A:** Yes, sure! Probably not in terms of revenue unless we change our business model totally, but in terms of numbers of companies rated, in terms of importance in the market and brand, I think that in 10 years from now there will be a whole different market and we can be very well known. It's a very concentrated market with a strong growth so we'll see who gets the biggest share.

16. How do you / will you differentiate from Credit Rating Agencies, now that they are investing in ESG screening?

**A:** The Business Model is still very different and right now only Moody's has a comparable number in terms of companies rated and still, they are smaller than us. Another one will be the brand recognition in the market in the eyes of the public, along with the experience and knowledge of the market and we've grown with this market.

17. Is there any kind of relationship between you and any Credit Rating Agency?

**A:** No.

<u>Future</u>

18. Where do you see ESG Rating Agencies in the future? How probable would you say these situations are?
    a. ESG Rating Agencies are as important as Credit Rating Agencies
    b. ESG Rating Agencies slowly fall out of the market due to Credit Rating Agencies addition of ESG Rating Services
    c. ESG Rating Agencies are acquired by Credit Rating Agencies
    d. Other

**A:** It's hard to predict what's going to happen but, ideally, option A would be the one I would desire and like the most. And now I would also say a new option, for D, which is the opposite of B, with Credit Rating Agencies falling out of the market and we start also providing financial ratings. Here what I mean is ESGRAs starting to buy smaller CRAs and try to do the integration as well as possible, which is really not easy to be successful, but why not? It can be a possibility for the future.

**Interview Elise Attal, Institutional Manager at Vigeo Eiris**

(done by phone on the 25th of April of 2019)

<u>Opinion / Current Situation</u>

1. What is your specific role in the organization? What are your main responsibilities and focus?

**A:** I am Institutional Manager at Vigeo Eiris and I've been in this position for about three years and my role is related to Public Affairs and Public Relations. I am in charge of all the academic partnerships that we have, developing the network of stakeholders of Vigeo Eiris, and I also monitor institutional relationships in terms of regulatory laws and frameworks that might have an impact on our business, especially at an European level. Nowadays there are many initiatives from the European Commission on sustainable finance so I am monitoring those evolutions and how it will impact our service. I am also involved in communication projects which aim at maintaining the reputation of the agency.

2. What is your opinion on the current state and position in the market of ESG Rating Agencies?

**A:** It is a very changing business area at the moment because the market is changing and consolidating. Last week, Vigeo Eiris signed a partnership with Moody's Investors Service. It demonstrates further that Credit Rating Agencies are entering the business of ESG, integrating historically smaller players that have been pioneers and very innovative in terms of sustainable investment. When it was created in Vigeo Eiris, we were developing in a very new and innovative area and now the market has grown, as there is more and more interest from investors in ESG which lead to the growth of our companies and now consolidation and maturity in the market. Also there are new legislations coming that will change a bit the way the market operates and we see as a very good opportunity for the entire market of ESG to grow because it was a very niche area in Vigeo Eiris early days but now it is much more open and mature, going towards finance, as finance is becoming more sustainable itself.

3. Who are they important to?

**A:** It is very important to different stakeholders. First, the companies, because they need to be rated by a third-party assessment which is recognized as valuable by the market. Ratings help issuers improve their sustainability strategies. Of course, it is also of interest to our clients, the investors (asset owners, asset managers, institutional investors etc.), who are now more and more demanding for ESG data to better evaluate the sustainable practices from the companies and associated risks, as well as opportunities, for instance companies contribution to the SDGs. Finally, I would say it is very important for stakeholders as a whole, clients, NGOs, trading unions, academics and anyone with interest in company's practices to benefit from better disclosure and transparency in regarding their sustainability performances.

<u>Functions / Best Practices</u>

4. What do you think to be the main objectives and functions of ESG Rating Agencies? Do you think they are all being met right now?

**A:** We are an ESG Data Provider, that is our core business. But we do not only collect raw data, we analyze and bring qualified opinion on the performance of the companies assessing all the risks and evaluating their performances against a set of different criteria. We believe that our main function in the market is to be a facilitator between companies and investors by answering the market failure of lack of information and to give an overall but also detailed picture of the ESG performance of 4800+ companies that we rate. Our main goal is to contribute to more sustainable financial markets, that is our main mission, and to do so, we collect and assess different information on companies and provide to the market a valuable analysis and opinion of how companies are performing. We deliver this information to our clients that will then be able to make informed investment decisions and to orientate their choices regarding investments on companies with the most advanced sustainable practices. Our research allows them to answer their own ESG investing objectives and define and match their own investment strategy.

5. What are, in your opinion, the Best Practices on giving ratings?

**A:** There are of course different types of methodologies on the market and each ESG providers have developed their own framework and their own rating process, although there are similarities. We believe an important best practice is trying to engage as much as possible with the companies and to provide the market with in-depth data and analysis, and that is something that we do well related to our competitors, in the sense that our methodology offers a lot of granularity in our assessment and we have a very solid framework with stable criteria that allows back testing and access to historical data. Each criterion is analyzed through 3 different angles: looking at the policy in place within the company; how the company is implementing, through appropriate measures, those policies; and finally looking at the results (if the company is actually achieving targets and having a positive trend in terms of its behavior). We also have a dedicated controversy assessment measuring if the company has a lot of allegations and how it is trying to mitigate and respond to it. Recently, we have issued “12 professional commitments towards the issuers that we rate” (Vigeo Eiris, 2019) and we think that is also an example of Best Practices because through our engagement with rated companies, we deliver quality of service. We have also recently been certified by the ISO9001 (Vigeo Eiris, 2019), which is quite exclusive regarding our competitors.

6. Are there any additional functions / services ESG Rating Agencies should focus on?

**A:** Currently, and that is also our bet at Vigeo Eiris through the partnership that we signed with Moody's, we believe that the market will restructure around two types of services. So far, ESG Rating Agencies have been developed on an Investor Paying Model, where it is the investor paying for the data, but now we are changing and developing an Issuer Paying Model, where the issuer will request specific rating agencies to rate them on their sustainability, as they already asked Credit Rating Agencies to assess their solvability risks. With this, they will be able to convince different types of investors that they have sustainable practices. And I believe that there will be a shift in terms of the services that the ESGRAs offer with an increase in direct services to issuers. One good example is the development of the Green Bond Market, where issuers require ESGRAs to provide a third-party opinion on their green bond issuance.

7. What would you mention as opportunities for ESG Rating Agencies and how to reach them?

**A:** As I already said earlier, new partnerships with recognized CRAs are a great opportunity to open up the door for ESGRAs to issuers and to get access to new types of markets and new investors that are also open to ESG. Working in closer relations with financial services is very interesting and this also brings a shift in the type of stakeholder we deal with in companies: we used to interact with the Head of CSR but now it is turning more to people from the financial department of the company, such as the CFO.

8. Which would you say are the challenges for ESG Rating Agencies, in the short and long term? Are there any problems to be solved?

**A:** The main challenge is, of course, the competition. This is a very competitive market and there is also too much consolidation which makes it hard to find the right business model and make it profitable. So, we need to invest more in R&D and in the development of methodologies, while at the same time investing in new technologies to really create more opportunities and improve ESG assessment. There is also disruption in the market with new practices as some investors are trying to create their own in-house methods, so they will only need us to provide them with raw data so they can do the analysis in-house. So, we have to convince them that they need our services and that our analysis has quality, demonstrating that our methodology is robust and has been developed and tested over more than 17 yeas. .

9. What efforts are already being put in place? What do you think to be the path to success (solutions) to overcome these challenges?

**A:** Client relationship is very important to show that our service is robust and has quality, plus it is very time-consuming and requires a lot of effort to make an in-house assessment.

ESG Rating Agency

10. Who are your customers? Is your service based on request or you rate all companies? Are you specialized in some type of companies or features?

**A:** We have more than 300 investors customers, from Asset Managers to Pension Funds and NGO's, and we have a worldwide presence now through the network of 4 partners. We rate on ESG more than 4600 companies worldwide and we rate them on the request of investors, so issuers are rated whether they want it or not. We rate any type of company, belonging to 40 different sectors. Then we are also developing the Issuer Paying Model for Issuers that want more in-depth analysis and to publish their own rating when they seek finance on markets.

11. What is the opinion of your customers on you? Any evidence?

**A:** We have launched a customer survey last year as part of the ISO certification and overall our clients gave us a grade of 8 out of 10 in terms of our services. We want in the future to have even more precise questions so that we know our customers even better.

12. How do you differentiate from other ESG Rating Agencies? What would you say is your competitive advantage?

**A:** We have the most in-depth ESG research on the market, with a consistent methodology, supporting back-testing and trend management. Our ratings are consistent and comparable, and we are transparent on how we rate companies. Our methodology is based on internationally agreed standards – providing credibility in dealing with public authorities and other stakeholders. We have recently achieved the ISO 9001 certification and of course our new partnership with Moody's also differentiates us from other ESGRAs.

Credit Rating Agencies

13. Do you see Credit Rating Agencies as a problem/threat, or as an opportunity?

**A:** We see them definitely as an opportunity, otherwise we wouldn't have entered in this partnership with Moody's.

14. And how do you think Credit Rating Agencies look at ESG Rating Agencies?

**A:** I think they also see us as an opportunity to benefit from our knowledge and methodologies developed throughout the years in this market. A lot of investors are now interested in ESG so CRAs also get interested in the topic.

15. Do you think you will ever have the dimension of Credit Rating Agencies?

**A:** Not applicable.

16. How do you / will you differentiate from Credit Rating Agencies, now that they are investing in ESG screening?

**A:** Not applicable.

17. Is there any kind of relationship between you and any Credit Rating Agency?

**A:** Moody's Partnership.

Future

18. Where do you see ESG Rating Agencies in the future? How probable would you say these situations are?

    a. ESG Rating Agencies are as important as Credit Rating Agencies
    b. ESG Rating Agencies slowly fall out of the market due to Credit Rating Agencies addition of ESG Rating Services
    c. ESG Rating Agencies are acquired by Credit Rating Agencies
    d. Other

**A:** We are basically reaching a Second Age for ESGRAs and ESG Assessment, which means basically that partnering with companies that have a higher weight in the market is the way to maximize the potential of development. I think it might be hard for ESGRAs staying alone to survive in the market, that is why also there has been so much consolidation and that is why we decided to partner now with Moody's. If you really want to become the leader in the market and to be considered as an international standard setter, I think it is a necessary shift and also a chance to offer complementary services in one stop shop for investors.

Moody's is becoming our main shareholder but Vigeo Eiris remains independent. This shows that Moody's recognizes the expertise of our employees and the quality of our methodology, and our common ambition to develop together the company. Moody's has created a specific entity which is based in Paris, called Moody's Investor Services Assessment (a subsidiary of Moody's Investor Services) and we are directly linked to this new entity.

# APPENDIX II – Interviews with Credit Rating Agencies

## Structure of the Interview

Opinion / Current Situation

1. What is your specific role in the organization? What are your main responsibilities and focus?
2. What is your opinion on ESG Rating Agencies?
3. And how do you think ESG Rating Agencies look at Credit Rating Agencies?
4. Do you think they are needed in the market?
5. What would you say are the biggest challenges on giving an ESG Rating? What solutions come up to your mind?

ESG Rating Agencies

6. What are your thoughts on Credit Rating Agencies efforts to include ESG Screening in their reports?
7. Do you want to differentiate from them? How? Do you think they do anything more or better than you?
8. Is there any kind of relationship between you and any ESG Rating Agency?

Vision

9. Do you see them as a threat or an opportunity?
10. Do you believe ESG Rating Agencies will ever have the dimension of Credit Rating Agencies? What do you think is lacking or will lack for this to happen?

Future

11. Where do you see ESG Rating Agencies in the future? How probable would you say these situations are?
    a. ESG Rating Agencies are as important as Credit Rating Agencies
    b. ESG Rating Agencies slowly fall out of the market due to Credit Rating Agencies addition of ESG Rating Services
    c. ESG Rating Agencies are acquired by Credit Rating Agencies
    d. Other

**Interview Andrew Steel, Global Head of Sustainable Finance at Fitch**

(done by mail on the 25th of April of 2019)

<u>Opinion / Current Situation</u>

1. What is your specific role in the organization? What are your main responsibilities and focus?

**A:** Global Head of Sustainable Finance. Responsible for developing and implementing Fitch's sustainable finance strategy, across the ratings business and the broader Fitch group. Main focus in to run a global team of rating and ESG experts to develop and implement ways in which to provide independent, insightful and rigorous analytical views and opinions on the credit impact of E, S and G risk factors on rating decisions. Fitch’s approach is to train its existing credit analysts in extracting and analyzing ESG risks thereby creating a fully integrated analysis model. Main vehicle for this is the recently released ESG Relevance Scores for rated entities (integral to the overall rating, and associated research)

2. What is your opinion on ESG Rating Agencies?

**A:** Extremely variable – methodologies often unclear and results inconsistent. Lacking the scale and rigor of traditional analytics. Very difficult to compare the output of different ESG rating agencies with each other due to variation in approaches. Can result in the same entity scoring top quartile for one provider and bottom for another whilst utilizing the same data set. Unregulated currently but probably needs to be given it is in early stage development.

3. And how do you think ESG Rating Agencies look at Credit Rating Agencies?

**A:** I think the ESG agencies probably consider the traditional credit rating agencies to be slow and inflexible in their approach. Some ESG agencies have suggested that there is more potential for conflicts of interest in traditional agencies given the issuer pays model, however an investor pays model where bonds are being assessed for say ‘green-ness’ contains just as much if not more potential for conflicts of interest. Real issue is how potential conflicts are recognized and managed within the organizations. ESG agencies are underestimating the risk issues here.

4. Do you think they are needed in the market?

**A:** There is clearly a role for trying to develop analysis around these types of risks and the sustainable ratings agencies have largely occupied this space to date. Investors, however, are looking for more detail and scale and so would like to see more of this type of work being done by the traditional credit rating agencies. Fitch has led the field in providing entity specific credit risk views on ESG starting from January 2019 – see www.fitchratings.com/esg for free access to the data and results.

5. What would you say are the biggest challenges on giving an ESG Rating? What solutions come up to your mind?

**A:** Lots of confusion over whether the rating is focused on equity or debt, as well as poorly defined timeframes for the views being offered (mainly backward looking analysis currently). Poorly defined analysis parameters and multiple unsubstantiated claims about results, without proper back-testing or substantive correlative analysis. Variability often blamed by ESG agencies (with some justification) on lack of consistent ESG data being provided by entities. Quality and consistency of ESG data disclosure is a significant market issue. Investors are looking to the big traditional credit agencies to help sort this out.

ESG Rating Agencies

6. What are your thoughts on Credit Rating Agencies efforts to include ESG Screening in their reports?

**A:** Fitch is the only agency to offer a comprehensive integrated approach to displaying transparently how E, S and G risk factors impact their credit decisions (but I would say that!). The other 2 big CRAs have taken an approach that requires separate engagement from the issuer. Your term ‘screening’ is slightly strange to me as that is more something an investor would do when constructing a portfolio. The big CRAs should all be including any risk aspect that is material to the rating already – the trick is then to be able to show exactly how that impacts the decision for an individual entity (again Fitch is doing this across all the entities which it rates with a standardized and consistent scale, the other entities are not).

7. Do you want to differentiate from them? How? Do you think they do anything more or better than you?

**A:** We (Fitch) have successfully differentiated ourselves from both the ESG agencies and the other traditional CRAs. The integrated approach of our ESG relevance scores is gaining substantial traction amongst investors.

8. Is there any kind of relationship between you and any ESG Rating Agency?

**A:** Our venture capital arm holds small minority stakes in two AI ESG data providers (early stage investments as part of a portfolio of tech investments)

<u>Vision</u>

9. Do you see them as a threat or an opportunity?

**A:** Not really a threat, but potentially an opportunity. Ultimately as disclosure from issuers and data quality and consistency improves (no lack of data volume), there will be substantial consolidation and there may be opportunities for the big CRAs to integrate these niche providers. Alternatively, some large niche providers may appear in this space, and then look to develop their CRA activities.

10. Do you believe ESG Rating Agencies will ever have the dimension of Credit Rating Agencies? What do you think is lacking or will lack for this to happen?

**A:** Scale, and therefore relevance, and regulation are the two biggest obstacles to ESG agencies competing with the traditional CRAs. Achieving critical mass in terms of coverage and analytical capabilities is a serious barrier to entry (huge costs involved and significant time before credibility can be established with capital markets investors and regulators (default and transition studies using consistent methodologies)).

<u>Future</u>

11. Where do you see ESG Rating Agencies in the future? How probable would you say these situations are?

    a. ESG Rating Agencies are as important as Credit Rating Agencies

       **A:** Unlikely

    b. ESG Rating Agencies slowly fall out of the market due to Credit Rating Agencies addition of ESG Rating Services

       **A:** Probable

    c. ESG Rating Agencies are acquired by Credit Rating Agencies

       **A:** Probable

    d. Other

       **A:** Consolidation results in two or more dominant ESG Rating Agencies which offer analysis that is complementary (different timeframes / different perspective to traditional CRAs.)

**Interview Elisabeth Burks, Sustainable Finance Team at Standard & Poor's**

(done by phone on the 2nd of May of 2019)

<u>Opinion / Current Situation</u>

1. What is your specific role in the organization? What are your main responsibilities and focus?

**A:** I am in the Sustainable Finance team and we cover sustainability issues across the various practices of S&P ratings. We have the corporate aspects, financial institutions practices, the structured finance team… We are a separate team that covers all the sustainable practices attached to different issuers. As a team we have three major themes: we work on ESG within the Credit Rating area, we also provide opinions on ESG Valuations and on the Green Financing Market, and thirdly we look into sustainability issues in the market, making a link between ESG and Corporate Financial Performance. Within the team, I focus on ESG and I do ESG Valuations on entities.

2. What is your opinion on ESG Rating Agencies?

**A:** We just moved into providing ESG Valuations and the core reason we did this is that in our core business of assessing credit ratings and the issuer's ability to pay back on their debt, both issuers and investors have been asking us to provide also opinions on ESG. So, we have begun to move into ESG Valuations and also writing some ESG paragraphs in the Credit Ratings, with the objective of making them more transparent to investors as this data is now more important for them.

3. And how do you think ESG Rating Agencies look at Credit Rating Agencies?

**A:** I am not sure.

4. Do you think they are needed in the market?

**A:** Investors and issuers have been asking us to provide more ESG data, and we cover thousands of issuers around the world, but we cover them looking at their credit quality, so there's an appeal to also deliver more ESG comments. In the end, it will be up to issuers and investors to decide.

5. What would you say are the biggest challenges on giving an ESG Rating? What solutions come up to your mind?

**A:** The credit rating, the result, has decades of experience of data and methodology. There is a huge amount of information on what is important throughout history, which let us provide a rating that is accurate and well perceived by investors in the market. Then once we move into the ESG theme, not on providing ratings but opinions of the ESG performance of the entities, we find that there is not a lot of data. I think that is really the biggest challenge, along with definitions. So far there are many words to describe the daily analysis, and different investors use different ones and especially different criteria. Some look at how companies manage their workforce in terms of safety, when others may consider the impact on consumers, initiatives on the product… So, there is not a huge amount of clarity on what those definitions are, and we have a big amount of work on that space, on understanding what to consider for ESG Valuations and what is material or not. We have been contacting the company and trying to understand them, in order to figure out the story behind the numbers, why the company puts this or that initiative in place and how is their risk management…

ESG Rating Agencies

6. What are your thoughts on Credit Rating Agencies efforts to include ESG Screening in their reports?

**A:** We have begun last year to provide some paragraphs on ESG last year and those will start to appear in all assessments of large companies. The reasons we are doing that is to increase transparency and showing what is material to investors.

7. Do you want to differentiate from them? How? Do you think they do anything more or better than you?

**A:** The reason why our clients and investors have been asking what we are doing in this space and the reason why we launched these initiatives is that, knowing we have a team of 1400 rating analysts around the globe and they assess financial materiality in terms of credit, they also understand business models, sectors, global differences, and so this view that we have on the credit side is very important for clients and investors. We publish the ESG factors linked to Corporate Financial Performance and so we feel that for those reasons we're able to offer a good ESG Valuation and assessment on ESG Factors, beyond credit because we are experts in providing financial benchmarks.

8. Is there any kind of relationship between you and any ESG Rating Agency?

**A:** There is none at the moment.

Vision

9. Do you see them as a threat or an opportunity?

**A:** I do not feel comfortable answering this question.

10. Do you believe ESG Rating Agencies will ever have the dimension of Credit Rating Agencies? What do you think is lacking or will lack for this to happen?

**A:** I do not feel comfortable answering this question.

Future

11. Where do you see ESG Rating Agencies in the future? How probable would you say these situations are?
    a. ESG Rating Agencies are as important as Credit Rating Agencies
    b. ESG Rating Agencies slowly fall out of the market due to Credit Rating Agencies addition of ESG Rating Services
    c. ESG Rating Agencies are acquired by Credit Rating Agencies
    d. Other

**A:** If we go to the market and we feel that need to provide value in that space. But I do not have an opinion and I really think this is going to be for markets to decide.

## APPENDIX III – Interview with Banking Sector

### Structure of the Interview

Opinion / Current Situation

1. What is your specific role in the organization? What are your main responsibilities and focus?
2. What is your opinion on ESG Rating Agencies? Do you think they are needed?
3. What do you see as the best in ESG Rating Agencies?
4. What would you say is lacking in ESG Rating Agencies?

Collaboration

5. Is there any type of collaboration between you and ESG Rating Agencies? Do you use their services?
6. If yes, which one? What made you use them in particular and not one of the others?
7. If they disappeared, would it be easy to change to another Agency and start using their ratings?

Credit Rating Agencies

8. Do you think ESG Rating Agencies will ever have the dimension of Credit Rating Agencies?

9. If Credit Rating Agencies start providing ESG Ratings, which services would you use on this matter?
10. How would you say ESG Rating Agencies can grow and get the same type of acknowledgement as Credit Rating Agencies?

Future

11. What would you say are the biggest challenges for ESG Rating Agencies? How to overcome them?
12. Where do you see ESG Rating Agencies in the future?

**Interview Governance Department at Banking Company**

(done by mail on the 30th of April of 2019)

Opinion / Current Situation

1. What is your specific role in the organization? What are your main responsibilities and focus?

**A:** I work in the governance department; my main focus is company engagement and voting.

2. What is your opinion on ESG Rating Agencies? Do you think they are needed?

**A:** ESG rating agencies are helpful for investors as they provide research on non-financial topics, and there is increasing interest in ESG integration into mainstream investing and investing in ESG funds. Furthermore, in recent years there have been prominent cases where so-called ESG risks materialized into severe financial risks (examples: Volkswagen emissions scandal; Peabody bankruptcy due to fuel substitution in U.S. electricity generation). However, while the research can be useful, it is not a good idea to rely on the ratings alone.

3. What do you see as the best in ESG Rating Agencies?

**A:** As we only use ESG rating companies for their research and not their ratings, I cannot say that one is definitely better than another.

4. What would you say is lacking in ESG Rating Agencies?

**A:** There is very little correlation between different rating agencies' company ratings. This is not necessarily "lacking", as it may be indicative of independence of thought, but is evidence that ratings on their own likely cannot be relied upon.

Collaboration

5. Is there any type of collaboration between you and ESG Rating Agencies? Do you use their services?

**A:** Yes

6. If yes, which one? What made you use them in particular and not one of the others?

**A:** CDP; we collaborate with them because we feel that they provide a valuable service for companies to deposit their climate, water, and forest related disclosures

7. If they disappeared, would it be easy to change to another Agency and start using their ratings?

**A:** We do not use their ratings.

Credit Rating Agencies

8. Do you think ESG Rating Agencies will ever have the dimension of Credit Rating Agencies?

**A:** No

9. If Credit Rating Agencies start providing ESG Ratings, which services would you use on this matter?

**A:** We do not use ratings. More broadly speaking, the focus on downside risks is in the DNA of credit rating agencies, and as such, their ESG analysis would possibly uncover ESG risks that could have financial dimensions and could be useful for large investors.

10. How would you say ESG Rating Agencies can grow and get the same type of acknowledgement as Credit Rating Agencies?

**A:** This is extremely unlikely because issuers need credit ratings to be able to sell their securities. Furthermore, behind the work of credit rating agencies, there is mathematics (probabilities of default and subsequent recoveries). The same exactitude is unlikely to be achieved by ESG rating agencies.

Future

11. What would you say are the biggest challenges for ESG Rating Agencies? How to overcome them?

**A:** I have not considered this too much, but the lack of consistency among ratings could be a challenge for the agencies.

12. Where do you see ESG Rating Agencies in the future?

**A:** The ESG rating space is quite fragmented compared to credit ratings, and if there is further consolidation, they could be more influential.

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