

Implications Of ESG Rating for Sustainable Development

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Abstract. This study discusses environmental, social, and governance (ESG) rating and the implications of its divergence. Generally, a company's financial performance is positively impacted by a high ESG rating. However, the phenomenon of ESG divergence brought about by different ESG rating approaches has implications for multiple parties. In the analysis, on the one hand, many investors are positive about ESG rating differences because it highlights the complexity of ESG analysis. On the other hand, investors will obtain detailed information and data from a wide range of ratings to more fully understand the root causes of conflict. In addition, different countries and regions have different approaches to dealing with ESG rating discrepancies. This paper suggests that establishing a uniform measure of sustainable economic activity through legal policies is more beneficial in reducing ESG rating divergences.

Keywords: ESG rating; ESG disclosure; Divergence; Investors.

1. Introduction

Environmental, Social, and Governance (ESG) disclosure is a form of public reporting on performance on a variety of "environmental, social, and governance" issues. There is a great deal of dispute on the sustainability aspects of investments, in contrast to the general agreement over the significance of ESG investments [1]. The methods used by ESG rating organizations to determine pertinent elements, evaluate information at varying levels of detail, identify data sources, and measure and weight factors vary. ESG rating agencies relate the numerous major variables that comprise the E, S, and G pillars to specific industries through the use of proprietary scoring algorithms [1]. Furthermore, the lack of formal auditing procedures to confirm given data and defined guidelines for the disclosure of social and environmental facts add to the subjectivity of evaluations. Accurate data is necessary for particular investment analysis [1]. An increasing number of responsible investors are beginning to consider a company's performance in terms of environmental, social, and governance concerns when making investment decisions, which has led companies to adopt stakeholder-oriented techniques to maximize social value [2]. ESG rating divergence inevitably emerges. Rating divergence is largely related to the practical challenges and variations in methodology that cause agencies to collect data differently. These difficulties include the following: choosing the raw data to use to gauge the effectiveness of these factors (measurement), missing data, and choosing pertinent variables (scope) [3].

This study looks at the divergence of ESG rating, evaluates ESG rating systems, and explores ESG disclosure strategies. High-quality ESG disclosure has a positive impact on corporate financial performance and provides better discipline for companies. With the increasing emphasis on sustainability, ESG rating organizations have become a dynamic industry. However, the lack of uniform standards for ESG ratings has created rating divergence. Some investors keep a positive attitude about ESG rating divergence because they believe it demonstrates the complexity of ESG analysis. However, the impact of ESG rating discrepancies is problematic. To address this, investors need more detailed data, and they can also compare the ESG rating with stock recommendations from equity experts. In addition, there are different ways of dealing with ESG rating discrepancies in different countries and regions. This article argues that setting a uniform definition and assessment of sustainability is more conducive to reducing ESG rating differences.

2. ESG Disclosure

2.1. Basic Information

Investors frequently lament that they are unable to make wise investment decisions due to the lack of availability and quality of company-level ESG disclosures [4]. Any nations have implemented ESG disclosure regulations that require companies to disclose high-quality ESG information alongside traditional financial disclosures or in specialized standalone reports [4]. This is in response to the gap between investor demand for ESG information and the availability of such information by companies [4]. Apart from the national endeavors, a noteworthy endeavor is underway on a worldwide scale to formulate, standardize, and ultimately enforce universal ESG disclosure guidelines [4].

2.2. Disclosure Method

Companies should organize their disclosures in accordance with the six categories of capital they employ: financial, manufactured, intellectual, human, social, and natural capital, according to the International Integrated Reporting Council (IIRC) [5]. They contend that corporate transparency on sustainability and environmental, social, and governance norms is considerably improved by such compliance [5]. To enhance the quality of disclosure, certain nations and areas—such as China, Denmark, South Africa, and Malaysia, which began in 2008, and Brazil, Hong Kong, and India in 2012—have instituted mandatory disclosure requirements on ESG information [6]. The ESG Disclosure Simplification Act of 2021, which was enacted by the US House of Representatives in June 2021 and is still pending legal status, mandates the disclosure of extra important ESG information about publicly traded corporations [6].

2.3. Impact on Corporate Financial Performance

By undertaking ESG activities, companies hope to achieve higher financial returns and signal compliance to the market [1]. After a series of robustness tests, including parallel trend test, Goodman-Bacon decomposition, dependent variable replacement, systematic GMM estimation, and placebo test, it is shown that ESG disclosure has a positive impact on enterprise financial performance [6]. ESG investors and companies with a longer history, greater media recognition, and higher agency fees tend to benefit more from ESG disclosure in terms of financial performance [6]. The good influence most presents on ESG investors and companies with long-established periods, high media attention, and high proxy costs [6]. Open and transparent ESG information increases public confidence and better disciplines companies. Investors, as one of the most significant stakeholders of the enterprise, have always been concerned about policy orientation and public demand, including product quality and humanitarian needs [6]. In a study by Engelhardt et al., the coefficient on the ESG indicator was positive and statistically significant when they performed a regression utilizing aberrant stock returns for market-adjusted completions following COVID-19 [7]. Based on the data, it can be inferred that a firm's abnormal returns during the collapse increased by an average of 2.59% for every standard deviation increase in the ESG score [7]. In addition, a company's idiosyncratic volatility decreases with increasing ESG score [7].

3. ESG Rating

3.1. Agencies

With the growing emphasis on sustainability, the ESG rating sector has expanded. ESG rating agencies are now a thriving and dynamic industry, even for "traditional" rating agencies, rather than isolated market players focused on a small financial market niche [8]. As one of the leading ESG rating agencies today, MSCI was formed by amalgamating a gang of other ESG research organizations that MSCI had previously purchased. MSCI analyzes corporate governance, social, and

environmental practices of thousands of companies worldwide [8]. In addition, The MSCI ESG Index was created using rating and research data from MSCI ESG [8]. There is strong evidence that using MSCI ESG rating in portfolios can assist in lowering the tail risk associated with individual stocks as systemic risk [9]. In the MSCI ESG rating process, they focus on 1) Identifying the risks that potentially have an impact on an enterprise's value. 2) Evaluating how well management has controlled these risks [9].

Another main source for investors to measure and trade the markets is S&P Dow Jones Indices, Inc [10]. It is also the leading global provider of fundamental index-based market concepts, data, and research [10]. They give a variety of ESG indexes to fit various risk, return, and ESG objectives by utilizing a broad range of sustainability data from SAM, a tag of RobecoSAM, an asset management firm focused exclusively on sustainability investing since 1995 [10]. Three primary categories comprise ESG indexes (S&P Dow Jones indexes, n.d.): 1) Core ESG: Consists of a best-in-class or positive screening process intended to enhance ESG performance while preserving features related to risk and return [10]. 2) Climate ESG: Evaluate business performance about various carbon reduction goals [10]. 3) Thematic ESG: Offers focused exposures to ESG topics, frequently with somewhat conservative goals [10].

3.2. Impact of ESG Rating

Market pressures and financial considerations have combined to drive the ESG industry's expansion [8]. Large public firms' initiatives, on the one hand, support the presence of proactive tactics to help them rank well in ESG rating [8]. Being a part of an ESG stock index incentivizes businesses to enhance their sustainability management, which benefits stakeholders and shareholders alike [8]. On the other hand, the scholarly and research community frequently uses the findings from ESG rating firms. As a result, ESG rating agencies have an impact on corporate sustainability management institutionalization as well as the actions of financial market participants [8].

4. Divergence of ESG Rating

4.1. Divergence of ESG

The lack of a common standard across ESG rating creates differences. Although, based on the generic taxonomy of Berg et al., the inferred aggregation criteria utilized by rating agencies may be calculated with an accuracy of 79-99%, indicating that it is possible to integrate ESG rating into a consistent framework despite their incompatible structures [11]. Berg et al. then discovered that, at 56% of the discrepancy, measurement disagreement was the primary cause of rating disagreement [11]. Weight dispute accounts for only 6% of disagreements; scope disagreement, on the other hand, accounts for 38%. Additionally, businesses that score highly in one category are more likely to be given high rating in all other categories by the same rater. There is a strong rater influence [11].

4.2. Perceptions of differences in ESG ratings

ESG rating disparities are seen favorably by many investors since they highlight how intricate ESG analysis is [12]. They contend that divergent views regarding an organization's ESG performance are inevitable due to the subjectivity of the ESG concept and that disparities in ESG rating are a factual rather than an issue [12]. However, for regulators or NGOs, Inter-agency convergence of ESG rating is facilitated by uniform quantitative disclosure in line with the sustainability reporting tools and standards they have developed.

5. How Investors Respond to the Divergence of ESG Rating

The majority of investors did not consider the disparity in the ESG rating to be a significant issue. ESG rating disparities are seen positively by many investors as a sign of the intricacy of ESG analysis [13]. They contend that differing opinions regarding a company's ESG performance are inevitable

since ESG is a concept that is prone to subjectivity and that differences in ESG rating are not issues but rather an accurate reflection of reality [13]. Due to the complexity of ESG, some investor thinks that conflicts over rating are inevitable. All investors concur, though, that there are issues with the impact of ESG rating dispersion [13].

To address the divergence in ESG rating, the general approach is to break down the rating into their constituent parts, examine the data at a finer level, and examine the data that underpins the rating rather than focusing solely on the results. Less investors may concentrate just on one rating agency and examine the rating in great depth to determine its meaning [13]. If they discover a discrepancy with other rating, they 36 attempt to provide an explanation using the dataset the rating was based on. More organizations gain from having more resources for analysis and data [13]. As a result, they can access a detailed level with a wide range of rating and obtain a more comprehensive understanding of the root of the conflict [13]. They can then make their own decisions about a company's ESG performance without depending on the rating [13]. Investors have also developed their internal algorithms to generate their own ESG performance assessment and compare it with the results of ESG rating to deal with rating divergence [13]. "There are many differences in the viewpoints and weightings of rating agencies [13]. The rating agencies' viewpoints and weightings differ greatly from one another. Some banks have synchronized their internal processes with the Sustainability Accounting Standards Board (SASB) guidelines in order to address this problem. They then created their own ESG performance assessment by inserting several manually selected data points on pertinent questions based on the SASB criteria [13]. Regarding varied ESG rating, another way to approach the issue was to compare them to equities experts' stock recommendations [13]. Due to the varying viewpoints of the data suppliers, ESG rating does not measure the same things [13]. Comparing ESG analysts to equity analysts, who also differ in their evaluations of performance, makes sense [13]. Ultimately, the investor's job is to do the analysis and decide what information to trust [13]. Divergence in ESG rating has affected investors from all various kinds of institutions [13].

6. How to Deal with Divergence of ESG Rating

6.1. US

As stock exchanges and financial regulators outside the United States have introduced public policies to advance sustainable finance and promote non-financial disclosure, United States Congress and the U.S. Securities and Exchange Commission's continued reliance on voluntary regimes, shareholder pressure, and other forms of private ordering to define the scope and content of ESG disclosure is becoming increasingly unusual [14]. Deep literatures in comparative law and policy as well as institutional theory provide important explanations for this divergence [14]. These theories note that the institutional foundations of a legal system have a direct impact on the possible scope of future regulatory reforms and their ultimate effectiveness [14].

6.2. EU

The EU Taxonomy is being developed by the European Union (EU) to harmonize the definition and assessment of sustainability [15]. The Taxonomy is composed of basic social safeguards, do no significant harm standards for the EU environmental objectives, and technical screening criteria defining substantial contributions (SC) to the six EU environmental objectives [15]. The EU's concept of activities promoting the ecological transformation of the economy can be defined in terms of the SC criteria [15]. Science-based standards ought to be used. So far, the Climate Delegated Act and the Complementary Delegated Act outline the minimal social safeguards and the criteria for doing no significant harm for each of the six EU environmental objectives, as well as the technical screening criteria defining SC to climate change mitigation and adaptation [15]. Definitions of technical screening criteria for SC to the remaining four EU environmental objectives should follow by the end of 2022 [15]. The Taxonomy is a key policy initiative within the finance part of the EU Green Deal [15]. The Taxonomy could help disaggregate the confusion of the environmental part of ESG rating

by harmonizing the measurement of sustainable economic activities, hence reducing measurement divergence [15].

6.3. China

In China, the idea of ESG investment is still very new and has only recently started to gain traction [16]. In China, the majority of ESG rating organizations only started providing rating in 2010, with some starting even later than 2016. Furthermore, the Ministry of Finance did not start encouraging listed companies to voluntarily declare their ESG performance until 2016 [16]. A range of rating is likely to emerge in emerging domains where evaluation standards and norms are not fully established, as noted by Christensen et al. [16]. Not to mention, the fact that retail investors dominate the Chinese stock market means that the effects of the stock price collapse will probably be especially bad in that country [16].

7. Conclusion

The article examines the impact of ESG divergence by exposing that ESG rating methods and disclosure of information can lead to rating divergence. In addition, the article explains how countries or regions respond to the impact. With a focus on sustainability, the influence of the ESG rating is expanding. ESG rating have a positive impact of the market as a whole as well as of individuals. Different ESG rating agencies and rating methods have arrived at the fact of the divergence of ESG rating. Many investors continue to view ESG rating divergence positively. Individual investors generally respond to divergence by breaking it down into its parts, examining the data at a more granular level, and examining the data on which the rating is based. When countries are confronted with discrepancies, the institutional basis of the U.S. legal system has a direct impact on the likely scope of future regulatory reforms and their final rating scores. The European Union is developing classification criteria to harmonize the definition and assessment of sustainability. In China, ESG investing is still very new and needs more time to improve and learn. Certainly, sustainability will be a topic that requires long-term research as well as improvement. There needs to be more emerging technologies to help researchers access ESG data and conduct related analysis.

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