ESG Rating Meaning, Function & application

Jiangshan Liu[1*+], Ziming Yin[2+], Shangyu Wang[3+]

ABSTRACT

ESG ratings assess company sustainability and ethics. Many agencies worldwide rate companies differently due to varying methodologies. Agencies focus on different indicators, scoring, and weightings. Key differences are that foreign agencies are more developed and integrated while China's are still evolving. Reasons for divergence include data availability, social factors, and subjective positions. For investors, the underlying data is more valuable than ratings to make personalized ESG evaluations. Companies should not chase ratings but improve risk management and competitiveness. Domestic agencies need more disclosure and integration with foreign ones to develop unique systems. Despite differences, ratings provide investment decision references and highlight ESG issues. With improvement, ratings can better inform stakeholders on sustainability.

Keywords: ESG, Function, application.

1. Introduction

ESG rating is in terms of environment, society, and governance. It is used to assess a company's performance on sustainability, ethical practice, and responsible corporate behavior in its operations and decision-making. Various agencies and firms provide ESG ratings, which can vary. Since every rating agency and firm has a different rating system and different weight on every aspect, it is common for a company to have two ESG ratings with a large difference. People build up the ESG rating system to better reference investment decisions, risk management, and performance analysis. With an ESG rating, investors can identify companies with their values and assess the potential and risk associated with their environment, society, and governance practices [1].

2. Logical thinking of rating

Different agencies have different ways of rating a company. For the environment, it is related to the company's impact on the environment, such as carbon emissions, air pollution, land usage, and natural resource management. The society part includes the relationship between the company and its employees, customers, and suppliers. It is mainly about labor practices, human rights, and diversity of ethnicity. Governance refers to a company's structure involving executive compensation, shareholder rights, and corporate governance practices.

3. ESG Rating Institutions

ESG rating is a rating agency's assessment of a firm based on environmental, social, and corporate governance factors, usually equating to a grade or level. Since 1983, when the ESG rating forefather Vigeo Eiris by Moody's was founded, hundreds of ESG rating organizations have sprouted worldwide. Aside from the MSCI, FTSE Russell, S&P Global, Refinitiv, Morningstar, and other well-known institutions have formed the ESG rating business, gaining widespread recognition and use among global investors. With the expansion of ESG in domestic investment, Chinese ESG rating firms have increasingly emerged. However, in foreign and domestic markets, the ESG process technique is used by the same fundamental entity, a rating agency. Typically, ESG rating agencies will resort to internationally recognized higher ESG standards and guidelines and build a set of ESG evaluation indexes based on their understanding of ESG concerns and study depth. Under the evaluation framework, ESG rating agencies collect enterprise ESG information through public channels or enterprise questionnaires, then according to the scoring criteria, the advance of the college enterprise each index of ESG performance analysis and grading, eventually ESG score and the corresponding rating are calculated [2]. ESG ratings successfully address the information asymmetry problem between investors and investment enterprises, assisting investors in identifying possible investment target ESG risk and value of ESG, and significantly lowering the cost of investment decisions. However, as time passes, the discrepancies in ESG ratings become more apparent, with the same company receiving varied ESG ratings within evaluation outcomes. This discrepancy and the abundance of ESG ratings have undoubtedly caused.

ESG investors a new fixation. A special note is needed: The different ESG hierarchy types used by the rating are different, so I can't compare directly. But on the whole, the main criteria are the same: Using the above standard, combined with horizontal and vertical contrast.

As a result, it is easy to see that the same company with ESG ratings has a bigger difference. Pingan Bank, as A benchmark reference, analyzes bank ESG rating results, ratings below its melting green to advance Ping a Bank, but the rest of the four given ratings are higher than that of Ping a Bank. Midea group, for example, again ZhongCai green gold courtyard give ratings are much lower than the ping a bank, while its green, OWL rating is only slightly lower than that of ping a bank, measuring social union and China CTI ratings are the same as the ping a bank is given. Even in a roughly horizontal comparison, the same company under different ESG rating industry positions is also different. In the case of the Midea group, comparing different ESG rating results found that the Midea group of ESG rated backward at the same time in the industry, the industry average, and the position of the industry by the former. In ESG, under the framework of the ESG, a rating agency, the basic choice of core issues formed a consensus. Such as climate change, resource consumption, investment and employment management, supply chain management, and community issues such as the board of directors structure are almost all of the ESG rating. But at the same time, there are still a lot of ESG issues that are only used by individual rating agencies. If we go deep into the level of specific indexes, the ESG rating agencies have adopted different numbers and different content of indicators. Index differences are mainly based on ESG research ability, understanding ability, and rating agency. Rating agencies generally choose easier assessment, access to, or processing of indicators and data. Therefore, some ESG rating systems contain thousands of indices, and some are less than one hundred. Using different index frameworks to evaluate the same company will produce the result of differentiation. To measure differences, ESG information, when faced with the same company, has different ESG rating focuses, so the scoring criteria are also different.

For example, some ESG performance results, a rating agency, some focus on policies and management measures, and some will consider information disclosure. The MSCI and the ESG assess the consistency of management and the corresponding risk exposure. This measure of the differences led to the ESG rating. While other ESG ratings are set up as a general index and industry index, weight distribution differences manifest the indicators in the industry. The existence of weight difference, each index score contribution of ESG ratings are different. Evaluation index, measure, and weight distribution differences are intertwined, causing the ESG rating result to finally be achieved. ESG rating differences are indisputable, but they also did not appear to have an “accommodationist” trend. How do you see the difference for the direct use of ESG rating for investors? First of all, all kinds of ESG ratings have certain reference values. Although the differences in ESG ratings at home and abroad, different application scenarios can play their role. The international mainstream ESG rating considerations and index issues are more abundant, but the content does not apply to Chinese enterprises. In addition, if the evaluation of Chinese enterprises by the “harsh” ESG performance standards may last, only a few enterprises stand out. This is not conducive to multiple-choice investment. And domestic ESG rating more joint ESG development of China’s actual and ESG status quo of Chinese enterprises. But under the global view, when making decisions, investors should choose a more international ESG rating system to evaluate the ESG performance of the different markets. Secondly, more valuable than ratings is the underlying data. Due to the lack of ESG standards, ESG ESG rating results can only represent the rating agencies to the college enterprise management or performance level of awareness. It is not the same, but different investors focus on ESG themes, and understanding of ESG has personalization. Therefore, the direct use of ESG ratings results in investors not reflecting the deep ESG investment demand. The better way is for investors and rating agencies to jointly develop and build the concept of their own ESG evaluation system, with the help of powerful data processing capabilities, a rating agency and complete data source, an ESG evaluation of potential investments, and precision lock investment targets.

In addition to the investment institutions and fund managers, an enterprise with an ESG rating is also of keen interest. For companies, ESG rating, especially the mainstream rating results, direct or influence the part of ESG funds. But if just holding the “test” mentality of ESG work, trying to get high marks in all the ESG ratings, often the wasted effort, even in vain or opposite. An ESG boost should be set out from the enterprise internal, risk management, market competitiveness, considering its importance from the dimension of reputation and so on, and not just as a means of attracting investment. Face the differentiation of ESG rating. As a result, the enterprises should take the initiative to communicate with the rating agencies and confirmation to ensure an objective assessment. The MSCI, S&P, and FTSE ESG rating agencies have established the enterprise communication and complaints mechanism. With the development of ESG investment into the mainstream, ESG rating numbers will be higher, and ESG evaluation dimensions will be more abundant. Through long-term development and perfection, even though the ESG rating method keeps individual differences, corporate ESG rating is.

4. ESG Rating composition

ESG evaluation can effectively alleviate the information asymmetry between investors and enterprises, and ESG rating is an important part. The evaluation principles of ESG ratings are not yet unified, and many debates still represent different worldviews and values [3]. So, there are many different ESG rating agencies today and many differences between different rating agencies at home and abroad. There are now more than 600 ESG rating agencies in the world; the first difference between domestic and foreign rating agencies is that foreign ESG rating agencies have now passed the development and transition period and have begun to integrate and become compatible between industries, compared to China's ESG rating agencies are still developing. It is the differences between domestic institutions and the rating coefficients abroad.

The most typical foreign examples are the MSCI, RUSSELL index, JONES series index, and so on. The main domestic rating agencies are China Securities, Wind, China Securities, etc. The first difference is the rating indicators; all indicators of MSCI are considered, while other institutions will take some indicators for assessment. All foreign rating agencies shown in the chart have chosen the scoring method. There are similarities, such as considering financial metrics.

Secondly, in addition to MSCI and KLD, most foreign rating agencies tend to track and rate those industries that performed well in the first rating. Although the development of domestic ESG ratings is later than that of foreign countries, the overall divergence is similar to that of foreign countries, and the only big difference is that there is not enough sample data in China, indicating that domestic ESG needs further improvement.

In addition to data differences, there are other reasons, such as social reasons, and different institutions have different subjective positions, such as opposed evaluations when foreign rating agencies evaluate domestic industries. Another major reason is the difference in technology; in addition to the difference in indicators, there is also the difference in topic coverage and weight. Finally, there are smaller differences, such as differences in the source of information, but today's networks can solve the problem of information.

Finally, the first step in developing domestic ESG ratings is to improve information disclosure and integrate with the international community. The second step is to have its own unique ESG rating system to reduce the difference between domestic and foreign rating agencies.

5. Conclusion

ESG (Environmental, Social, and Governance) ratings aim to assess and evaluate a company's performance in these three areas. These ratings help investors, stakeholders, and the public understand a company's sustainability practices, ethical behavior, and management quality. ESG ratings can guide investment decisions, encourage responsible business practices, and promote transparency and accountability. ESG principles can be applied across various industries and sectors, including finance, energy, technology, healthcare, and more. ESG considerations are relevant in climate change, diversity and inclusion, labor practices, executive compensation, and corporate governance. The applications of ESG are wide-ranging and intended to promote responsible and sustainable practices in corporate and investment decision-making. Predicting the future of ESG is challenging, but the trend toward a greater focus on sustainability, social responsibility, and ethical governance will likely continue. Companies and investors are expected to place increasing importance on ESG factors due to growing awareness of environmental issues, social inequality, and corporate ethics. Regulatory changes, technological advancements, and public demand for responsible business practices will likely shape the future of ESG.

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All authors contributed equally to this work and should be considered co-first authors.

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