**Senate Bill 7: Prohibiting ESG Investment - Article 2**

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# ESG scores: The good, the bad, & why they matter

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Today's investors are beginning to look beyond the bottom line to understand company value and long-term sustainability. ESG (Environmental, Social, Governance) disclosure provides investors with a way to identify and understand key issues that aren't typically accounted for on a traditional balance sheet yet have a critical impact on a company's risks and opportunities.

Consumers, investors, and employees continue to value ESG and sustainability as it becomes embedded as a part of forward-looking corporate strategies. Studies show that 66% of global consumers, including 73% of millennials, are willing to pay more for sustainable goods. By 2026, ESG-related assets under management (AuM) are expected to increase to $33.9 trillion, which would account for over one-fifth of total global AuM.
As the market surrounding ESG expands, investors are demanding new tools to assess how companies perform from an ESG standpoint. With an estimated $17 trillion in sustainable investment capital on the line, the stakes are high for companies and investors to make sound ESG decisions. To do this, institutions such as asset managers, pension funds, and endowments, often rely on ESG scores. But what exactly is an ESG score?

## ESG scores in a nutshell

An ESG score is a measure of how well a company addresses risks with respect to environmental, social, and governance issues in its day-to-day work and operations. This includes topics such as climate change adaptation, energy efficiency, employee health & wellbeing, diversity, equity, & inclusion (DE&I), and human rights. Once overlooked, thanks to ESG reporting and case studies, these topics have been shown to have a significant impact on a company's bottom line in addition to obvious sustainability benefits.
A strong ESG rating indicates that a company manages its ESG risks well in comparison to its peers, whereas a poor ESG rating indicates that the company has comparatively higher unmanaged ESG risk exposure. ESG evaluations and scores, when combined with financial analysis, can help investors gain a better understanding of a company's long-term potential for positive, sustainable growth.

## What do ESG scores measure?

Each ESG factor has its own set of standards that contributes to the overall ESG score. Environmental criteria measure a company's impact on the environment and their strategy to improve them. Social criteria examine a company's interactions with their social environment, such as local communities, their employees, and other stakeholders. Governance criteria examine corporate responsibility, which can include topics like business ethics and executive pay.
Environmental issues can include:

- Carbon emissions

- Climate change vulnerability
- Water sourcing
- Biodiversity & land use
- Toxic emissions & waste
- Packaging material & waste
- Electronic waste

Social issues can include:

- Labor management
- Worker safety training
- Supply chain labor standards
- Product safety & quality
- Consumer financial protection

Governance issues can include:

- Composition of the board in terms of diversity & independence
- Executive compensation
- Accounting practices
- Business ethics
- Tax transparency

ESG rating companies also consider the opportunities within different ESG categories. For example, environmental opportunities can include clean technology, green building, and renewable energy while some social opportunities can be better access to communication, finance, or healthcare.

All of these risks and opportunities offer insights into the company that reveals a comprehensive picture of an organization's environmental footprint and green initiatives, how much the company invests in the community, and how well they'll hold up against relevant laws and regulations and any legal controversies.

### *Who calculates the ESG scores?*

ESG rating agencies are third-party companies that specialize in ESG scoring. In the US, there are **over 140 firms** that provide ESG scores, each with a slightly different approach with their rating system. Some of the prominent ESG score providers include Bloomberg ESG Data Services, Dow Jones Sustainability Index, MSCI ESG Research, Sustainalytics, Thomson Reuters ESG Research Data, S&P Global, ISS ESG, Vigeo/EIRIS, Fitch Ratings, and Moody's Investors Service.

### How is an ESG score calculated?

Because each ESG rating firm calculates scores based on proprietary algorithms and individual criteria, no two will score a company the exact same way. In general, ESG performance is based on data gathered from a variety of sources, including securities filings, voluntary business disclosures, governmental databases, academic research, and media reports. Any **ESG data** that a business has made available through voluntary disclosure frameworks, such as the Global Reporting Initiative (**GRI**), the Value Reporting Foundation's (VRF) **SASB Standards**, **CDP**, and the UN Sustainable

Development Goals (**SDGs**), can serve as a significant source of data for most rating providers. These metrics are divided into environmental, social, and governance scores, which are then merged into a single primary rating.
Using analysts and algorithms, the companies convert ESG metrics like a company's carbon emissions, board diversity, or safety procedures into siloed environmental, social, and governance scores, which are then merged into a single primary rating.

For example, MSCI examines hundreds of metrics and assigns a score of 0 to 10 to corporations on each important issue. These issues are weighted on their timeliness and probable impact. Issues with the greatest potential for impact (within two years) have the highest weights, whereas issues with less potential for impact and a timeline of five years or more have the lowest weights. After assigning percentage weights to ESG risks, companies are compared to their peers and given a final rating.

Ultimately, companies are categorized by MSCI as leaders, average, or laggards.

- ESG **leaders** are proactively managing ESG risk and taking advantage of ESG opportunities better than their peers. Leaders have AAA or AA ratings.
- **Average** ESG performers may be managing some key issues well and others poorly, or they may be average across the board. Average ratings include A, BBB, and BB.
- **Laggards** have relatively more unmanaged exposure to ESG risk factors and receive ratings of B and CCC.

### *What is a good ESG score?*

Investors can compare a company's performance to that of industry peers and companies from other sectors by assigning an ESG score, which can range from 0-100. A score of less than 50 is regarded as poor, while a score of more than 70 is considered excellent.

Ratings can also be described as either excellent, good, average, or poor:

- An **excellent** ESG score indicates that best practices are being followed in all ESG areas and a company has little to no internal or external problems.
- A **good** ESG score signifies that a company is meeting best practices in each ESG category and has a low negative impact on people or the planet.
- An **average** ESG score indicates that companies are not on track to meet ESG benchmarks or actively working toward meaningful ESG goals.
- A **poor** score indicates that no best practices are being followed and are indicative of a company that is negatively impacting the environment and has employees who are being poorly treated.

### Why do ESG scores matter?

Investors prefer companies with better overall ESG scores because they typically have fewer liabilities, making it easier to acquire capital and hire top talent. These companies also often have successful stakeholder relationships and a brand reputation. All of these factors have an impact on the profitability and bottom line of a business.

ESG scores allow investors to gauge the company's intentions actions, from how they treat their employees to how the board decisions are made or if environmental issues are being prioritized.

A high ESG score may persuade investors to engage, either because the company's values align with their own or because the company is sufficiently protected from future risks associated with issues like pollution or poor governance. An investor who is concerned about ESG may be turned off by a company with a low ESG score.

Companies with a low ESG score are thought to have the worst environmental, social, and governance impacts. Undesirable ESG scores have also been linked to rising poverty levels in the communities where the firm operates, as well as poor employee mental health.

### ESG score limitations & how to address them

While ESG information can be useful when combined with other metrics, investors should not rely entirely on ESG scores to drive their investing decisions. The ESG score is not a reliable predictor of market success on its own, and there are numerous concerns with the existing lack of rules and transparency surrounding the criteria utilized for grading.

Recently, however, agencies worldwide have sought to address these concerns. Regulators in the US, UK, and EU recognize the need for a more uniform set of rules when it comes to ESG metrics. For example, in the US, the Securities and Exchange Commission (SEC) is working to **standardize climate-related disclosures** by public companies with the hope that it will aid in improving the accuracy of the ESG ratings of these companies. In the UK, the Financial Conduct Authority (FCA) has announced the formation of a group to develop a **Code of Conduct** for ESG ratings providers. In the EU, the European Securities and Market Authority (ESMA) is considering introducing **regulatory safeguards** for ESG ratings. As these agencies work towards a standardized, global agreement on **ESG frameworks** and ratings system, the transparency and validity of ESG scores will continue to increase.

### How to get started with ESG scoring

Your ESG ratings are only as good as your ESG data and disclosures, meaning the more robust your data is, the better your ESG scores are likely to be. Setting ESG targets, capturing key indicators and outcomes relevant to your industry, and ensuring this data is transparent and reliable are all good places to start.