SDGs: a new focus for non-financial rating agencies

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In the midst of a significant restructuring, the non-financial rating landscape is adapting to new investor demands. After a focus on investment portfolio carbon footprint, rating agencies are working on a new emerging phenomenon: measuring corporate performance on the Sustainable Development Goals (SDGs). Everyone has a different approach to apply the 17 SDGs and their 169 targets.

The rise of sustainable finance has accelerated over the last three years with the adoption of the 2015 Paris Agreement, the Task Force on Climate-related Financial Disclosures (TCFD) recommendations on climate risk reporting in 2017 and the EU action plan on sustainable finance released in 2018. A growing number of stakeholders need to incorporate environmental and social dimensions in their investment decisions, which presents new developments for ESG ratings agencies. The specialized agencies are discreet about their financial turnover, but MSCI said it has increased its activity in this area by more than 20%, reaching $54.8 million in 2017. The market is growing, and americanizing, as it is gradually being dominated by major international players, such as MSCI and ISS.

American actors dominate the ESG rating market

Major financial data providers took a stand since 2010 by acquiring ESG specialists (RiskMetrics purchase of Innovest, and later MSCI) and establishing strategic partnerships (Morningstar with Sustainalytics) to allow their clients expanded access to non-financial data. Since then, these strategies have reached a new dimension. In July 2017, Morningstar acquired 40% of Sustainalytics, and in early 2018, ISS bought oekom research AG (now ISS-oekom), a German pioneer in non-financial ratings. These consolidations demonstrate the gradual disappearance of the small structure market, in favour of major American players who can bring new means for development. Today, the main players in the market are MSCI, ISS and Sustainalytics, which is reminiscent of the credit rating market dominated by three US agencies, S & P, Moody's and Fitch.

Acquisition Strategies

American financial actors		
S&P Global	ISS	MORNINGSTAR
Control via its subsidiary S&P Dow Jones Indices LLC	ISS controls the below three agencies and renamed them	Strategic partner owning 40% of the agency
Purchased specialised rating agencies		
TRUCOST	ISS-oekom, south pole, ISS Ethix	SUSTAINALYTICS

novethic

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Acquisitions concern **environmental rating specialists**

As environmental and, more specifically, climate gain importance, business valuation specialists in this area have become attractive takeover candidates. In October 2016, S&P Dow Jones Indices LLC acquired Trucost (now S&P Trucost), a British pioneer in corporate environmental performance ratings. In 2017, ISS acquired the climate finance division of the Swiss environmental consulting firm, South Pole.

Towards a common framework for “non-financial” ratings?

The increasing importance of ESG criteria in investment decisions is leading regulators to better monitor the non-financial ratings that have developed without legal framework until now. In its EU action plan on sustainable finance, the European Commission wishes to «explore the merits of amending the Credit Rating Agency Regulation to mandate credit rating agencies to explicitly integrate sustainability factors into their assessments». In addition, it plans to conduct an exhaustive study of the ESG rating market in 2019, particularly regarding the methods used, the quality of research and the independence of these research/rating providers.

Main characteristics of the non-financial rating market

Investor Demands	Products and services
Align ethical values with investments	ESG analysis (focus on the ESG performance of operations). Exclusion of controversial products and practices
Identify and manage ESG risks	ESG analysis (risk focus, better consideration of financial materiality)
Identify and manage climate risk	Measurement of the carbon footprint and climate risks of issuers
Have a positive environmental and social impact	Second party opinions of green sustainable bonds. New tools for evaluating company performance based on SDG criteria

Source: Novethic

Responsible investors are changing their expectations. Their search for impact and financial materiality influences the very notion of a so-called ”non-financial” rating:

- **Evaluation of the materiality of ESG risks:** Initially, the financial and ESG analyses were based on different models. Financial analysis uses standardized models to estimate a company’s future profits and the value of its stock. ESG analysis is based on a multi-criteria approach and historical company data. Development in what is considered climate risk with very high financial costs, encourages new models based on the financial «materiality» of environmental and social dimensions based on future results. This demonstrates a shift from a retrospective to a prospective notion.

- **Measuring the impact of ESG integration in investment decisions:** Initially, responsible investment approaches were based on the analysis of policies and processes implemented by large listed companies on various ESG dimensions: Environment (CO^2 emissions, water consumption, etc.), Social (accidents at work, forced labour in the supply chain, etc.) or Governance (independence of management boards) to ensure compliance with their values and their investments. Today, many investors want to go further and measure the environmental and social impact of their portfolios. This approach was first environmental, and more specifically, focused on the climate. But investors are expanding their practices and gradually adopting the Sustainable Development Goals (SDGs) as a shared reference to communicate the impact of their actions. They have, thus, formulated new requests to non-financial rating agencies which, as a response, are developing new valuation models not yet standardized.

Adopted by the United Nations in September 2015, the 17 Sustainable Development Goals (SDGs) are broken down into 169 targets, operating on a global scope, with the goal to be achieved by 2030.

The SDGs have quickly become a reference for large institutional investors such as Dutch and Scandinavian pension funds. To meet this demand, asset management companies began developing new "SDG" fund offers.
This has led invested in listed stocks, with rating agencies to offer new SDG-related products and services linked with impact measurement.

The Challenge of measuring impact

Developments in impact investing have led to the development of social impact analysis models. In general, these models have three dimensions: outputs (or «products»), outcomes and impacts. In the diagram below produced by the Avise, resources and activities are the means implemented to generate impact. This approach is also used to measure the impact of listed company activities.

Measuring positive contribution

What is produced?		What is contributed?
OUTPUTS	**OUTCOMES**	**IMPACTS**
Products obtained as a result of the actions taken	Immediate effects of actions on their target	Social, economic, environmental consequences, attributable to these actions
Example: an environmental education association is conducting an awareness project on sorting waste		
80 participants - 1 awareness booklet produced	23% increase in the number of households practicing selective sorting	Increase in sorted waste tonnage by 11% due to the awareness plan

Source: EVPA

This approach is relatively easy to implement for a small structure but what about measuring the impacts of a large company with varied business activities and significant negative contributions?

It is therefore a double complex challenge faced by non-financial rating agencies. They are developing indicators to measure the overall contribution of companies to sustainable development, whether positive or negative. To accomplish this, they analyze company operations, or the impact of the goods and services they produce.

Characteristics	ESG Sustainable Impact Metrics	Sustainability Solutions Assessment	Sustainable Development Analytics
	MSCI	ISS-oekom	SUSTAINALYTICS
Coverage	2,900 issuers on social themes, 8,900 on environmental themes	75% of the universe analysed (approximately 4,000 issuers), and full coverage promised by mid-2019	Approximately 4,500 companies
General Approach	In April 2016, MSCI launched a methodology assessing the alignment of company products and services to its SDG classification as it is related with the ESG rating. The tool allows for an assessment of exposure to the SDGs at portfolio and/ or company level, but only in a positive dimension.	In 2016, as part of its ESG impact service, ISS-oekom created a methodology to measure the negative, neutral or positive contribution of business products and services by using its own SDG classification. The tool illustrates exposure to the SDGs at portfolio and/or company level.	Since early 2018, Sustainalytics has been evaluating the SDG alignment of companies analyzed. The approach is based on an alignment of operations (including the supply chain) on one hand, and product alignment on the other. The tool allows them to illustrate exposure to SDGs across investment portfolios and company-wide.
SDG scope and themes covered	MSCI regrouped the 17 SDGs into the following: • Basic needs: Nutrition, Major Diseases Treatment, Sanitation, Affordable Real Estate • Empowerment: SME finance, Education • Climate Change: Alternative Energy, Energy Efficiency, Green Building • Natural Capital: Sustainable Water, Pollution Prevention, • Governance: Bribery & Ethics, Governance Structure	The 17 SDGs are translated into the following: 8 environmental goals (Achieving sustainable agriculture & forestry, conserving water, contributing to sustainable energy use, promoting sustainable buildings, optimizing material use, Mitigating climate change, Preserving marine ecosystems, Preserving terrestrial ecosystems) and 7 social goals (Alleviating poverty, Combating hunger & malnutrition, Ensuring health, Delivering education, Attaining gender equality, Providing basic services, Safeguarding peace)	Sustainalytics says it conducts an overall alignment assessment on the 17 SDGs. Currently, a more specific definition of Sustainalytics own objectives is not publicly available.
SDG Evaluation Measurement	Portion of turnover related to SDG products and services and other themes defined by MSCI	Share of turnover related to products exposed to 15 SDG themes as defined by ISS-oekom • For each theme, scoring ranges from -10 to +10, according to the negative alignment (obstruction), neutral or positive alignment (contribution) of the activity • Weighting of the 15 scores according to sectoral «materiality» of the SDG themes • SDG final scoring (from -10 to +10) combining the two data.	Based on a «value chain» approach, Sustainalytics achieves a global score of 0 to 100 by weighing equally two indicators (strategy alignment, product alignment). Concerning strategy alignment, Sustainalytics uses the ESG performance measurement and SDG readiness level. For product alignment, it assesses the nature of the activity and its compatibility with the SDGs. For example, the production of renewable energy that contributes to achieving the goals, or tobacco that prevent them from reaching them.
Analysis of SDG Company strategy	For now, the MSCI tool does not include analysis of the overall corporate strategy on the SDGs. They are working on this.	In the overall ESG assessment, ISS-oekom makes a qualitative judgment on the ambition of the company's strategy to transform its product / service portfolio into a more responsible portfolio.	Sustainalytics does not have a specific indicator to measure the integration of the SDGs in the business strategy but proposes a more global analysis.
Coverage of company value chain	If the tool is focused on products measured against SDGs, a minimum ESG quality is required. The MSCI ACWI Sustainability Impact Index excludes controversial companies.	The SDG tool focuses on the product but the ESG performance of operations is taken into account in the global ESG evaluation of the company.	Sustainalytics explains to analyse the global exposure of products and services (including the supply chain).

Table produced by Novethic according to data provided by the agencies concerned.

Sustainable Development Goals Assessment	SDG Evaluation Tool	ODD et Midcaps
vigeoeiris	TRUCOST	EthiFinance
4,200 companies	Testing in progress on a dozen companies	More than 500 companies (small and medium-sized listed companies)
Since 2015, VigeoEiris has developed a methodology for evaluating and classifying companies' contribution to the SDGs. The agency questions and notes the impact of corporate products and services on the UN Sustainable Development Goals and measures the impact of companies' strategy and their operations on the 17 SDGs and their associated targets.	S&P Trucost wants to develop a comprehensive value chain analysis of companies that covers positive and negative contributions to the SDGs. The tool should enable companies to assess their position vis-à-vis the SDGs and compare themselves to their peers in this area.	EthiFinance offers a global rating with three SDG exposure levels. Companies may have broad, significant, or minor exposure to the SDGs
VigeoEiris explains to cover all SDGs and proceeds with their contextualization and weighing according to the size, sectors and place of business activity. The rating for the level of SDG integration in the strategies and products and services of companies is classified into 8 topics, of which 5 relate to behaviours (Natural Capital, Social Welfare, Human Capital, Business Ethics and Governance) and 3 relate to product impact (Climate Change, Development tools, Healthy Lives).	For its methodology, Trucost reclassified 169 targets that correspond to the 17 SDGs in order to define 49 indicators.	Ethifinance has selected 10 SDG themes: • air quality • energy • waste and infrastructure • water • transport • poverty • education • health and security • nutrition • housing
The evaluation is carried out on a five-level SDG contribution scale (highly positive, positive, marginal, negative, highly negative).	For its 49 indicators, Trucost uses the following template to establish a final score that ranges from 0 to 100: Establishing an SDG exposure profile for the company to identify which ones are most important. Then, it analyses the company's SDG performance, based on sector weighting and by comparing the company with its main competitors. Finally, it assesses the positive contribution through value creation and risk of non-compliance with the SDGs.	The share of activities that are directly affected by the SDG themes selected by EthiFinance
The agency specifically questions the systematic integration of action principles and SDG objectives into corporate policies, processes, and control/ reporting systems.	Trucost carries out a global analysis of the company's policy by looking at how it seeks to mitigate the risks related to the lack of achievement of the SDGs and its positive contribution to their achievement.	Each company is subject to a global evaluation of its ESG management with no specific recourse to the integration of SDGs in the business strategy.
Holistic approach: analysis of the company's behaviour (integration in governance, strategy, processes throughout the value chain, including suppliers) as well as the product portfolio of companies.	The total value chain (economic, social, environmental) of a company is analysed: supply chain, operations, products and services included	The SDG tool focuses on products marketed by the company or on technologies offering solutions to sustainable development issues.

Converting the SDGs into **thematic approaches**

Rating agencies use a variety of data to calculate company exposure to SDGs. However, the calculation is based on a similar principle: agencies cannot conduct a detailed impact assessment for all activities. Instead, they have a more comprehensive thematic approach. Agencies define their own frame of reference using the 169 targets associated with the 17 SDGs. Then, they analyze financial data to assess, for example, turnover related to the SDGs and/or strive to establish scoring systems according to the degree to which companies are aligned with the SDGs (e.g. significant, limited, neutral).

Steps to Measuring Sustainable Impact at the Portfolio Level

Anecdotal	Exposure to impact theme	Define sector specific metrics	Define outcome	Estimate outcomes
Provide case studies and qualitative example of impact generated at the company level	*Measure exposure to companies which provide solutions to some of the world's largest environmental and social challenges in a consistent manner accross sectors*	*Define metrics that are specific to each sector. For exemple: - Healthcare: R&D pipeline, differential pricing strategies - Consumer: availability, accessibility, quality*	*Define outcome based metrics for each theme. For example: - Climate change: avoided emissions - Finance: number of SME financed*	*Develop estimation model based on specific region and sectors if possible. For example: - Education: number of students sent to college in emerging markets - Healthcare: number of HIV treatments developped per year*
Current approach		Potential future approach		

Source: MSCI ESG Research

These products allow investors to choose impact indicators (for example, the number of sick days avoided for pharmaceutical companies, such as the UBS Global Sustainable Impact Equity Fund). However, we are starting to see consistent indicators for various sectors.

Differing definitions for similar SDG themes

Many of the targets defined by the SDGs are qualitative and do not correspond with the reporting produced by large listed companies. On the other hand, some SDGs, such as those concerned with energy or climate change (SDG 7 and 13) allow for more standardized approaches based on taxonomies like those proposed by Climate Bonds Initiative. The following is an explanation of general approaches applied to large companies:

SDG 2: Zero hunger

This goal aims to ensure global food security by strengthening the productive capacity of small producers and preserving the genetic diversity of seeds. Many large agribusiness-listed companies seek to optimize their harvests by reducing the number of seeds and genetically modified plants. So, what SDG rating should they be given? Should their activity be classified as a positive contribution to the SDGs or a negative one? Agency responses are highly variable. Some do not cover this issue as they lack information on company turnover, others take into account only companies operating with sustainable certifications, and others do not give details on their definition of sustainable agriculture.

SDG 3: Good health and well-being

To enable everyone to live healthy lives, the targets formulated for this goal mainly concern the eradication of diseases in emerging countries, through preventive measures (vaccines) and access to medicine. Large pharmaceutical companies have economic models where the largest, neglected diseases often play a small role. Some agencies focus on the SDG rating of companies that treat the 20 largest global diseases, as defined by the WHO. Others integrate the entire pharmaceutical industry by distinguishing different levels of contribution and integrating any ESG controversies into their analysis.

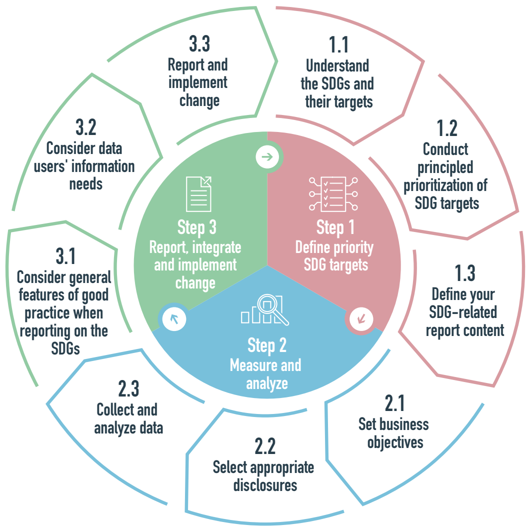
Companies **barely starting to report on SDGs**

A relevant SDG analysis is based on the quality of the data provided by the companies and their ability to publish ambitious strategies by 2030. This would require not only measuring and amplifying positive company contribution to the SDGs but also evaluating and reducing the negative impact on the SDGs, and their ability to achieve the SDGs. There's still a long way to go!

SDG Reporting: in theory

The Global Compact and the GRI published a practical guide in the summer of 2018 to help companies set up their standardized reporting using an approach that can meet the expectations of agencies and investors.

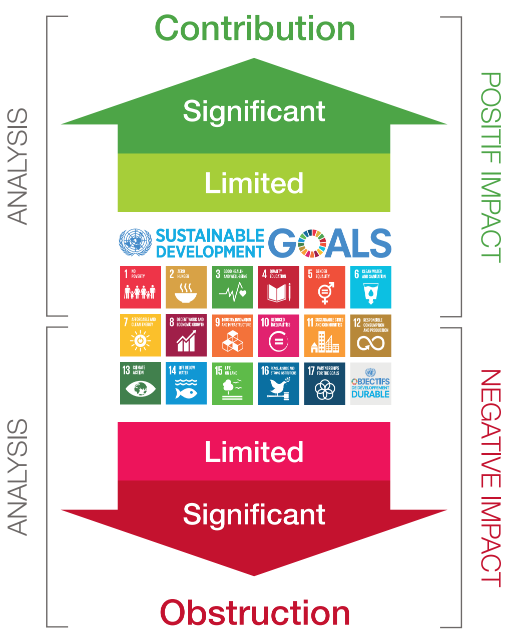
To make things easier, the two organizations have launched a reporting platform on SDGs so that companies can share best practices, but this is currently a pilot program that only includes approximately 40 companies.
https://www.unglobalcompact.org/sdgs/action-platforms



Source: SDG Reporting Guide (Global Compact GRI)

Strategy analysis: the missing link

Business turnover is a volatile and limited information that does not provide a forward-looking vision how business activities relate to the SDGs. To measure their positive or negative contribution, it is necessary to analyze how the SDGs are taken into account in the company's business strategy. However, rating agencies emphasize the need for corporate transparency to have a robust framework for analyzing SDG reporting. Today, companies are barely reporting on this aspect. Agencies must be satisfied with a qualitative analysis based on standard ESG indicators. This SDG assessment is often considered as a supplemental analysis in fine-tuning an ESG rating that is largely based on data provided by companies. This is why the impact being considered is that of products and services, which constitute the essence of the analysis provided by agencies today.
With that said, agencies are at a very different stage of maturity when it comes to measuring the impact of operations and evaluating the entire supply chain. Only half of the six agencies whose offers have been analyzed, indicated that they cover the entire supply chain.



Source: ISS-oekom, adaptation Novethic

Gap between investor expectations and existing SDG reporting

The SDGs are increasingly seen by investors as a framework for assessing the environmental and social impact of their responsible investment approaches. Their ambition is not only to be able to demonstrate the positive alignment of their investments with the SDGs but also to assess the ESG risks associated with the obstruction that companies could cause while achieving the SDGs. Rating agencies are trying to adapt their models to this new demand by analyzing not only the positive contribution of companies, but also their negative impact. Only two of the six agencies whose offers have been analyzed explicitly propose this service: ISS-Oekom and Trucost S&P, through a test version involving a dozen companies. This shows that it may be premature to develop a large offer for SDG funds or, for large investors, one that includes an SDG dimension in their reporting. Companies expose themselves to the risk of "SDG washing" in the absence of relevant, consistent and reliable impact indicators. On the other hand, this urgent demand will enable companies to better understand the need to improve reporting on the subject.

Lack of data limits SDG rating possibilities for agencies

The Sustainable Development Goals (SDGs) are becoming a universal reference shared by states, companies and investors. Rating agencies strive to quickly respond to investor demand. They have developed tools that are methodologically close to thematic approaches in the environment and the social sector. These tools allow investors to have a general idea of the capacity of the companies analyzed to contribute to the 2030 agenda through their products and services, and to identify sectors whose activity is most favorable to the SDGs.

The analysis of the methodologies they propose shows the differences in approaches, but none is able to offer an exhaustive view (products and operations, contribution and obstruction, varying levels of commitment and impact) with robust indicators concerning a large number of companies. The lack of data combined with the difficulties of adapting some of the targets underpinning SDGs to financial data makes the task difficult. This is reinforced by the lack of consensus on the definition of sectoral indicators or the impact measurement, whether it is for food or health for example.

The challenge of SDGs forward-looking analysis

Today, large listed companies have not put SDGs at the heart of their strategy and do not measure their impact across value chains using specific indicators. In the absence of reporting on SDG integration in business models, it is difficult for rating agencies to make a refined and forward-looking assessment.

To push this dimension, initiatives are being developed such as the Positive Impact proposed by UNEP-FI. Its goal is to implement a holistic approach in identifying companies that have integrated these SDG considerations in their strategy and applying impact management that follows the schema below:

Identification
- Principles
- Radar

Analysis
- Significant impacts
- Definition of KPIs to use
- Clarification of baselines
- Specification of targets if applicable

Measurement
- Predictive Models
- Back-testing

Disclosure of:
- Process
- Outcomes

Assessment based on:
- What impacts
- How much
- How diverse
- Business model (additionality)
- Degree of assurance

Source: Positive Impact (UNEP-FI)

Analyzing the integration of the SDGs into the corporate strategy would allow agencies to engage in forward-thinking analysis and move closer to a financial rating. A focus on both the future impacts of an economic model in relation to the SDGs and ESG criteria with a high financial materiality, would reconcile ESG integration and impact measurement approaches in order to provide a prospective and global company rating. We are likely at the beginning of a broader movement leading the SDGs to becoming the frame of reference for companies concerned not only with having a globally positive contribution to the planet but also to guarantee the long-term sustainability of their business model. This model can be seriously threatened by major environmental crises such as biodiversity loss or climate change, as well as major social or health problems.

SDGs: a new focus for non-financial rating agencies

A study from the Novethic research centre, conducted by Stefan Fritz under the supervision of Anne-Catherine Husson-Traore.