Corporate Social Responsibility Rating Agencies: Comparing Rankings, Methodologies, and Philosophies

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INTRODUCTION

Objectives

- Identify CSR rating agencies' **purposes and philosophies** on CSR
- Identify differences in CSR rating agencies' **methodologies**

Key terms

- **Corporate social responsibility (CSR)**: a company's approach to environmental, financial, social and philanthropic actions
- **Social investing**: considers the social good, as well as profit of a corporation when making investment decisions
- **ESG**: Stands for Environmental, Social, Governance; categories of CSR factors and a framework used by multiple rating agencies

METHODS

- I compared methodologies, purposes, and philosophies with material from each CSR rating agency's respective website.
- I compared three social indexes/sets of indexes: Dow Jones Sustainability Indexes, FTSE4Good Series, and MSCI KLD 400
- Project partly based on "Breaking Down the Wall of Codes: Evaluating Non-financial Performance Measurement" by Aaron Chatterji and David Levine

RESULTS

Comparing Methodologies

Weighting of issues

FTSE4Good:

Exposure-weighted average—"the most material ESG issues are given the most weight when determining a company's scores." Exposure = "measure of the relevance for a company of each theme"

MSCI:

Risk management requirements to score well vary based on each individual company's risk exposure.

"Key issue weights are set at the GICS Sub-Industry level (8-digit) based on each industry's relative external impact and the time horizon associated with each risk."

Dow Jones:

Analysis of financial materiality for each industry determines weights of various sustainability criteria

Issues rated

FTSE4Good: 3 Pillars (ESG), 14 Theme Scores, 350 Indicators, typically 10-35 per theme

Some sector-specific indicators

MSCI: 3 pillars (ESG), 10 themes, 37 key issues, "thousands of data points"

Some key issues are universal, and others depend on the industry. Only rates issues deemed material to industry

Dow Jones: 3 dimensions, each with a set of criteria that varies depending on industry

Only issues "relevant to the companies' success"

RESULTS

Rating scale

FTSE4Good: 0 through 5

MSCI: AAA, AA, A, BBB, BB, B, CCC

Dow Jones: 0-100

Is bar for inclusion relative to industry, relative to all firms, or absolute?

FTSE4Good: Absolute

MSCI: Relative to industry (sector weights) and relative to all firms (400 constituents are included at one time)

Dow Jones: Relative to industry. Companies are given absolute rankings between 0-100, but then the top members of each industry are included in index

Data collection method

FTSE4Good:

Based on publicly available information, not private surveys, "to improve credibility of data and enhance transparency"

MSCI:

100+ specialized datasets (government, NGO, models), company disclosure (10-K, sustainability report, proxy report), 1600+ media sources monitored daily (global and local news sources, government, NGO)

Dow Jones: Industry-specific questionnaires (between 80-120 questions for factors relevant to the company's success) "This allows RobecoSAM to analyze sustainability at a much deeper level than frameworks based on public disclosure alone."

Must be invited to be assessed

Screening for selection in index

FTSE4Good: As of October 2016, a company in a "developed" market needs a 3.1 to be added and below 2.5 to be deleted. A company in an "emerging" market needs a 2.0 to be added and below a 1.8 to be deleted.

Selling the following excludes you: tobacco, weapons systems, components for controversial weapons, cluster munitions, anti-personnel mines, depleted uranium, chemical/biological weapons, nuclear weapons, and coal--companies categorized within the Industrial Classification Benchmark Subsector of 1771 Coal.

Companies involved in nuclear power generation or manufacturing baby formula must meet special requirements

A "Controversies Service" is being developed (as of October 2016). Companies that have significant controversies will not be included.

A score of 0 in a high exposure theme excludes "developed" market companies

MSCI: Companies that receive too much revenue from the following are excluded: alcohol, gambling, tobacco, military weapons, civilian firearms, nuclear power, adult entertainment, genetically modified organisms

A company must have a rating above BB to be eligible for inclusion. Existing constituents must maintain above a B.

A company must have an MSCI ESG Controversies Score above 2 to be eligible for inclusion. Existing constituents must maintain a score above 0 (on a 0-10 scale, 0 being the worst score).

Dow Jones:

Top ranked companies within each industry are selected (top 10% for global indices, 20% for regional indices, and 30% for country indices)

Only the largest companies are eligible

Companies must have a score no less than 40% of the highest rated company's score to be included in an index

Investors can invest in "ethical exclusion sub-indices" that exclude companies with exposure to: alcohol, tobacco, gambling, armaments, cluster bombs, firearms, landmines, adult entertainment, nuclear weapons, nuclear power generation, nuclear power sales, and uranium mining

Comparing Purposes and Philosophies on CSR

FTSE4Good

Listed purposes:

- Portfolio evaluation and manager due diligence
- Engagement and stewardship
- Risk management
- Research and analysis
- Custom benchmarks
- Active portfolio management
- Actively encourage companies to address ESG issues

"Not a 'Best-in-Class' index with a narrow and constrained stock universe, but rather is meant to capture a broad universe of companies that are working to manage and improve ESG performance" unlike Dow Jones

RESULTS

MSCI

To "help investors to understand ESG risks and opportunities and integrate these factors into their portfolio construction and management process"

To answer the following questions:

- "Of the negative externalities that companies in an industry generate, which issues may turn into unanticipated costs for companies in the medium to long term?"
- "Conversely, which ESG issues affecting an industry may turn into opportunities for companies in the medium to long term?"

More specific four key questions:

- "What are the most significant ESG risks and opportunities facing a company and its industry?"
- "How exposed is the company to those key risks and/or opportunities?"
- "How well is the company managing key risks and opportunities?"
- "What is the overall picture for the company and how does it compare to its global industry peers?"

"A risk is material to an industry when it is likely that companies in a given industry will incur substantial costs in connection with it"..."An opportunity is material to an industry when it is likely that companies in a given industry could capitalize on it for profit"..."The MSCI ESG Ratings model focuses only on issues that are determined as material for each industry"

Represents a "best-in-class" approach with strict criteria

Dow Jones

Just like MSCI, companies are evaluated based on "financially relevant sustainability criteria." Questions focus on "factors that are relevant to the companies' success, but that are under-researched in conventional financial analysis."

"A family of best-in-class benchmarks for investors," unlike FTSE4Good, to "ensure a high sustainability profile for index constituents, while maintaining a balance in terms of industry exposure"

Language on the website heavily emphasizes the financial benefit of CSR

Qualifiers when mentioning stakeholders imply CSR is optional and only relevant for a specific subset of investors. "Benchmarks for investors who integrate sustainability considerations into their portfolios, and provide an effective engagement platform for investors who wish to encourage companies to improve their corporate sustainability practices"

CONCLUSIONS

- The most popular social indexes vary widely in purposes, philosophies on CSR, and methodologies
- These differences cause problems, as discussed in the literature
- Specifics of methodology not immediately evident to the average stakeholder nevertheless have large implications for the meaning of these indexes' results
- These indexes view and advocate CSR as beneficial primarily for profit, rather than ethical reasons.
- Because the Dow Jones Sustainability Indices and MSCI KLD 400 only focus on issues relevant to company profit, they are not reliable measures of a company's social output outside a financial context.
- Although these indexes have changed throughout the years, problems indicated in the literature a decade ago remain today.

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