Proceedings of the 2nd International Conference on Financial Technology and Business Analysis
DOI: 10.54254/2754-1169/64/20231520

Towards a More Reliable ESG (Environmental, Social, and Governance) Assessment Framework: Lessons from the PRI Initiative

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Abstract: In recent years, green investments and ESG (Environmental, Social, and Governance) principles have gradually become the focus of the industry's attention. However, the future of ESG still has some uncertainties, and the diversity of ESG data and metrics has led to challenges in comparing ESG performance across companies, making it complex to determine the relevance and substantive ESG issues related to financial performance. This paper explores the evolution and challenges of ESG investments and proposes principles for ESG rating agencies to follow, originating from the PRI (Principles for Responsible Investment). This study recommends that rating agencies adopt a comprehensive assessment approach, considering a company's environmental, social, and governance performance and engaging with companies to obtain more comprehensive and reliable data. Additionally, rating agencies should maintain transparency, disclosing precise methods and data sources to enhance the credibility of ESG ratings. Most importantly, rating agencies must continuously improve their rating methodologies to reflect changes in the market and ESG practices, encouraging other rating agencies to adopt more consistent ESG assessment methods for a more sustainable investment practice and sustainable development in the financial industry.

Keywords: ESG, Ratings, PRI Principles, Sustainable Development

1. Introduction

ESG stands for Environmental, Social, and Governance, representing the three dimensions of environmental, social, and governance that provide a comprehensive perspective for evaluating a company's sustainability and ethical values. It emphasizes focusing on financial returns and considering a company's impact on the environment, social responsibility, and sound corporate governance. Therefore, ESG has evolved from a moral obligation into a financial strategy with strategic importance for both companies and investors. Companies and investors increasingly realize that effectively managing ESG risks and opportunities is crucial for achieving long-term financial sustainability. However, as mentioned, determining which ESG issues are relevant and substantial for a specific company's financial performance can be a complex and challenging task, with one of the biggest challenges being the diversity of ESG indicators and benchmarks. Since

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ESG data and indicators have not historically been part of mandatory financial reporting frameworks, numerous different measurement methods have made cross-company comparisons challenging. Therefore, this paper will study the diversity of ESG indicators and benchmarks and their impact on cross-company ESG performance comparisons. It will also explore methods to promote consistency in the ESG field, enhancing the comparability and credibility of ESG data, thus gaining a deeper understanding and assessment of the impact of ESG on a company's financial sustainability. This will help rating agencies provide more accurate ESG information, assisting investors, corporate leaders, and policymakers in better supporting sustainable economic development.

2. Literature Review

2.1. Domestic Research Status

Hou Dongde and Wei Yajun (2023) suggest that a comprehensive and inclusive disclosure model should be implemented through mandatory full-coverage and appropriate inclusion, creating information disclosure standards that align with China's market development reality and have Chinese characteristics. This will promote the combination of external supervision and internal self-regulation, establish an ESG information disclosure framework for listed companies under the new development concept, and achieve the integration of localization and internationalization. You Yi (2022) proposes measuring corporate governance performance from the perspectives of company organizational structure and norms, compliance and internal control systems, company vision and strategic planning, company performance, intellectual property, and innovation, designing a corresponding indicator system. Wang Xiaoshu and Wu Zhe (2020) introduce ESG ratings, ESG indices, and ESG analysis. The MSCI rating model assesses the ability of companies to achieve fair, sustainable development through four aspects: ESG risks faced by the company, the degree of risk exposure, handling capacity, and peer comparison, allowing investors to have a more comprehensive understanding of ESG risks and opportunities.

3. Research Methodology

3.1. Literature Review Method

This research conducted searches on platforms such as China National Knowledge Infrastructure (CNKI) and EBSCO using phrases such as ESG, rating standards, information disclosure, and other keywords. A large number of domestic and international scholarly articles on measuring ESG and sustainable development were read to explore how to achieve greater consistency in the ESG field, improve the comparability and reliability of ESG data, and better understand and evaluate the impact of ESG on a company's financial sustainability. This will help provide more accurate ESG information for investors, corporate leaders, and policymakers, supporting sustainable economic development.

4. About ESG

4.1. Concept

ESG, which stands for Environmental, Social, and Governance, has its origins traced back to a significant historical moment in 2004. The term gained widespread attention when then-United Nations Secretary-General Kofi Annan invited 55 major financial institutions' CEOs to participate in an international initiative. The initiative aimed to integrate environmental, social, and governance factors into capital markets and promote sustainability and social responsibility. The pivotal 2005 report titled "Who Cares Wins" was significant because it presented a business case for incorporating ESG factors into investment decisions for the first time [1]. This report emphasized that by considering ESG factors, investors could enhance market sustainability and achieve better social and environmental outcomes [2]. This period marked the beginning of ESG concepts entering mainstream finance and investment, and it continued to grow in significance over the following years.

Since then, ESG has become a global issue, representing a value system for sustainable development with the goal of harmonizing human and environmental coexistence. It has influenced finance, business, and government institutions, driving the development of sustainability and social responsibility. Unlike traditional metrics that focus on a company's profitability and financial condition, ESG investments prioritize assessing a company's value from a non-financial perspective, emphasizing long-term value growth while considering both economic and social benefits. It has evolved into a comprehensive framework that guides investors, companies, and policymakers to consider environmental, social, and governance issues holistically and actively participate in shaping a more sustainable future. This historical milestone demonstrates the influence and importance of ESG, which will continue to shape global financial and business practices.

4.2. Research Status

It can be challenging to determine which ESG issues are financially relevant and substantial for a specific company. Due to the historical absence of ESG data and indicators in mandatory financial reporting frameworks, there have been various methods, making cross-company comparisons challenging. Although efforts are being made to introduce more standardized sustainability reporting methods globally, the current situation remains chaotic and fragmented. As highlighted in the 2020 report by the Organization for Economic Co-operation and Development (OECD) titled "ESG Investing: Practices, Progress, and Challenges," a complete ESG financial ecosystem now exists, ranging from issuers to end investors, rating providers, companies constructing ESG indices, standard setters, and disclosure organizations, all of whom can use different definitions and indicators [3].

The establishment of the International Sustainability Standards Board (ISSB) and the work by the Organization for Economic Co-operation and Development (OECD) to establish more standardized sustainability disclosures are in progress. The OECD has also issued policy recommendations to strengthen ESG investment and financing, including measures to enhance the transparency of ESG ratings. All of this takes time. In the meantime, caution is needed. ESG indicators reported by companies often mask issues of concern from a risk perspective. ESG ratings from different providers have weak correlations, reflecting differences in proprietary methodologies, weighting schemes, and substantive assessments. Indeed, there is a debate on whether it is reasonable to weigh different aspects of the three pillars of ESG—Environmental (E), Social (S), and Governance (G).

5. PRI Principles

5.1. About the PRI

The integration of Environmental, Social, and Governance (ESG) factors into the financial sector is a significant indicator of the development of ESG investments. The Principles for Responsible Investment (PRI) is an international initiative launched with the support of the United Nations in 2006. It aims to encourage investors to incorporate ESG factors into their business and investment processes. The following are the six principles of PRI [4]:

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1. Incorporate ESG Issues into Investment Analysis and Decision-Making: Include ESG issues as part of the analysis and decision-making process for investments.
2. Be Active Owners and Incorporate ESG Issues into Ownership Policies and Practices: Actively engage with investee companies on ESG issues and integrate them into ownership policies and practices.
3. Seek Appropriate Disclosure on ESG Issues by the Entities in Which We Invest: Encourage transparency by seeking disclosure of ESG issues from the entities in which investments are made.
4. Promote Acceptance and Implementation of the Principles within the Investment Industry: Promote the adoption of the Principles within the Investment Industry.
5. Work Together to Enhance Effectiveness in Implementing the Principles: Collaborate with other signatories to enhance the effectiveness of implementing the principles.
6. Report on Activities and Progress Towards Implementing the Principles: Report on activities and progress towards implementing the principles.

One of PRI's primary goals is to encourage investors to consider ESG factors comprehensively and integrate them into their investment decisions. By signing PRI, investors commit to considering ESG issues in their investment practices, aiming for sustainability and social responsibility.

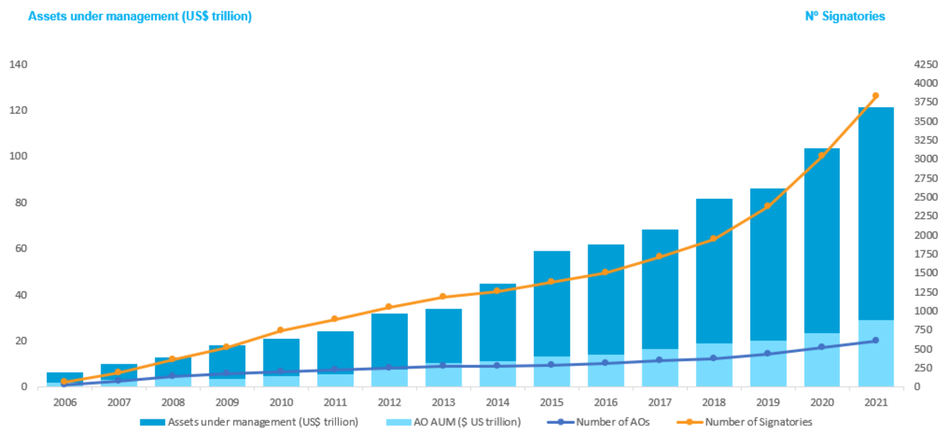

Figure 1: PRI growth 2006-2021

As is shown in the chart, the number of investors signing PRI has significantly increased since its inception [5]. More and more financial institutions, asset management companies, pension funds, and other investors have joined this initiative. This reflects the growing recognition of the importance of ESG factors in investment decisions. As more investors sign PRI, the assets covered also significantly increase. This means that a substantial amount of investment capital is now guided by PRI principles, all of which commit to considering ESG factors, which is crucial for advancing sustainable investments and ESG practices [6]. PRI's presence helps drive the global financial sector towards more consistent ESG standards and practices [7]. It encourages investors to share best practices globally, promoting transparency and comparability of ESG information. The growth of PRI reflects the expanding influence of ESG investments. More investors realize that considering ESG factors helps manage risks and contributes to long-term investment returns and social responsibility [8]. PRI encourages investors to comprehensively consider ESG factors in their investment practices, pushing the financial sector towards a more sustainable direction. The success of this initiative reflects the increasing global focus on sustainability and social responsibility in the financial sector and the trend of adopting ESG principles in investment decisions.

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5.2. Research Recommendations

In addition to investors, rating agencies complying with PRI principles can ensure that their ESG assessments align with PRI's objectives, thereby enhancing the consistency and credibility of ESG ratings, promoting sustainable investment development. This is crucial for encouraging companies to adopt more sustainable business practices, providing investors with more comprehensive information, and supporting social and environmental responsibility. This research provides several recommendations for rating agencies to comply with PRI principles, with the expectation of transforming them from mere data providers into catalysts for sustainability transformation, bringing greater value to the entire investment ecosystem.

5.2.1. Comprehensive ESG Assessment

Rating agencies should comprehensively assess a certain company's or portfolio's ESG performance [9]. This should encompass not only a company's performance in environmental, social, and governance dimensions but also how these factors are integrated into its core business operations.

Environmental (E): In the environmental dimension, attention should be given to a company's environmental impact and sustainability practices. This includes carbon emissions, energy and resource efficiency, waste management, water resource management, and more. Rating agencies should examine a company's environmental policies and practices and assess whether there are risks and opportunities related to climate change and ecosystems.

Social (S): The social dimension focuses on a company's impact on society, including employees, supply chains, communities, and social responsibility. Rating agencies should assess aspects like employee well-being, labor relations, diversity and inclusivity policies, supply chain management, and social responsibility practices. They may also consider a company's community engagement, charitable activities, and social impact. Social assessments help investors understand a company's social reputation, risks, and socially-related opportunities.

Governance (G): The governance dimension covers a company's governance structure and practices. This includes board structure, independence, compensation policies, shareholder rights, transparency, and accountability. Rating agencies should evaluate whether a company has robust governance structures to ensure that management decisions are transparent, fair, and in the interest of shareholders. Comprehensive governance assessment helps investors gauge management quality, risk management capability, and governance practices that safeguard investor interests.

By considering these three dimensions comprehensively, rating agencies can provide a holistic view that assists investors in better understanding a company's sustainability performance. This helps investors incorporate ESG issues into their investment analysis and decision-making, making more informed investment choices aligned with their sustainability goals.

5.2.2. Transparency and Credibility

Traditional ESG ratings often rely on publicly disclosed information such as company reports and financial documents. However, this information may not be comprehensive and could be influenced by a company's self-reporting and selective disclosure. Rating agencies adhering to PRI principles should actively engage with companies to obtain more detailed and credible ESG data. They can achieve this through communication with company management, employees, data providers, and other stakeholders, as well as through site visits and surveys [10]. This proactive approach enhances the accuracy of ESG ratings as rating agencies gain deeper insights into a company's ESG practices and performance. These data sources can not only be used for ratings but also to support companies in improving their ESG performance. Rating agencies indirectly assist companies in better managing ESG risks and opportunities by providing more comprehensive and detailed data. At the

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same time, rating agencies should disclose transparent methodologies and data sources to explain the basis of their ratings. This helps investors understand the foundation of the ratings, ensuring their reliability and reducing the risk of information asymmetry.

5.2.3. Continuous Improvement

Rating agencies must regularly review their rating methodologies to reflect market changes and the evolution of ESG practices. This includes improving data quality, updating rating methods, enhancing transparency, and responding to feedback from investors and other stakeholders. As advocates of PRI principles, these agencies will set an example in the industry, prompting other rating agencies to adopt similar, more consistent ESG assessment methods. Rating agencies play a crucial role in the ESG field, as their ratings can influence investor decisions and corporate behavior. If some major rating agencies adhere to PRI principles and employ more consistent ESG assessment methods, other agencies may feel pressured to maintain competitiveness and credibility by adopting similar approaches. This competitive pressure helps establish higher industry standards, ensuring the quality and credibility of ESG assessments. Investors and companies can have more confidence in the ratings from these PRI-compliant rating agencies as they align with broader industry consensus. This contributes to building a more transparent and reliable ESG assessment system, providing better decision support to investors and companies. Rating agencies, in collaboration with companies, can enhance the effectiveness of implementing the principles.

6. Conclusion

This paper delves deeply into the evolution, challenges, and prospects of Environmental, Social, and Governance (ESG) investments and offers a series of recommendations regarding ESG rating agencies' adherence to the PRI principles. Firstly, this paper reviews the origins of the ESG concept. ESG has evolved from a moral obligation to gradually become a strategic imperative for both businesses and investors. However, the ESG landscape is characterized by diverse data and metrics, posing challenges for cross-company comparisons of ESG performance. Secondly, this paper presents rating recommendations rooted in the PRI principles to enhance the consistency and feasibility of ESG ratings. Rating agencies should adopt a comprehensive assessment approach that considers a company's environmental, social, and governance performance to improve the comprehensiveness of ratings. Maintaining transparency and credibility is of paramount importance. Rating agencies should actively engage with companies to obtain more detailed and trustworthy ESG data and disclose clear rating methodologies and data sources. Additionally, rating agencies need to regularly review and improve their rating methodologies to adapt to evolving markets and ESG practices. Furthermore, this paper underscores the importance of the PRI principles in the field of ESG investments. The growth of PRI reflects the expanding influence of ESG investments, urging investors to comprehensively consider ESG factors and integrate them into investment decisions, thereby propelling the financial sector towards greater sustainability.

In summary, this paper provides essential insights into understanding and applying ESG principles. It encourages rating agencies, investors, and business leaders to take action towards achieving a more sustainable economic and social development. Through the adoption of more consistent ESG standards and practices, we can collectively work towards establishing a more transparent and trustworthy ESG assessment framework, providing better support for sustainable investments and business operations.

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