WHITE PAPER

ESG ratings and the issue of measuring governance performance

Environmental, Social, and Governance (ESG) ratings are increasingly being used by investors and stakeholders to understand a company's sustainable practices and overall impact on society.

However, when it comes to the 'G' or the governance part of the ESG equation, accurately measuring and assessing corporate governance performance can be a complex and challenging task.

This white paper explores the concept of ESG ratings, the difficulties of measuring governance performance highlighting real-life examples from Goldman Sachs, Steinhoff, Facebook and Volkswagen, and the potential solutions to these issues whilst proposing an 11-step framework for organisations to facilitate the process.

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Understanding ESG ratings

ESG ratings have gained significant popularity in the corporate world and the investment community over the past couple of years due to the major spike in demand for sustainable investing and ESG-related data globally. In a recent study, Brian Tayan from Stanford University has identified the following three key reasons for this:

1. **Retail investors' increasing concern over the environmental and societal impact of the companies they invest in.** More and more investors are making more prudent investment decisions and looking to invest in sustainable companies whose products and practices are aligned with their personal values.

2. **Institutional investors aiming to meet their clients' increasing demand for ESG-friendly investments.** To respond to their clients' changing investment behaviour, many institutional investors have started to take into account companies' environmental or social impact and performance in their portfolio construction and product development practices.

3. **Companies striving to make a positive impact.** With consumers and investors' social and environmental expectations on the rise and the ever-increasing regulatory requirements, companies are recognising the need to act on sustainability.

As the need for ESG data increases, the significance of clear and trustworthy information that enables the evaluation of available investment choices also escalates. And here's where third-party ESG ratings have come into play. According to research by SustainAbility in 2020, ESG ratings are the most common reference point for institutional investors when assessing ESG performance.

Typically performed and published by market data and analytics agencies like Institutional Shareholder Services (ISS), CDP and MSCI, ESG ratings have thus been developed to provide investors with an objective, independent data-driven assessment of ESG-related factors. They also enable companies to benchmark their sustainability performance against their peers and identify areas for improvement.

What are ESG ratings?

A spectrum of ratings products that are marketed as providing an opinion regarding an entity, a financial instrument or a product, a company's ESG profile or characteristics or exposure to ESG, climatic or environmental risks or impact on society and the environment that are issued using a defined ranking system of rating categories, whether or not these are explicitly labelled as "ESG ratings".

Source: The European Commission (ESMA)

What do ESG ratings measure?

Broadly speaking, ESG ratings aim to measure and provide insights into an organisation's ESG quality. But with no formal industry standardisation of what "ESG quality" actually means, assessment methods and factors vary significantly among different ESG ratings providers.

A common theme among most providers though is investment risk reduction because of the underlying assumption that high-quality ESG performance reduces social and environmental risks which could threaten a company's operations and existence. For instance, MSCI asserts that its ratings aid in mitigating ESG risk and fostering long-term value, while Morningstar's Sustainalytics evaluates the potential risk to a company's economic value from ESG factors. If these providers' assumptions and measurements are accurate, we should see a correlation between ESG ratings and subsequent risk events, as reflected in financial performance or a lower likelihood of regulatory violations, litigation, or bankruptcy.

However, not all ESG ratings providers shape their scorings simply around risk reduction. Some explicitly design their scores to forecast returns. HIP, for instance, suggests that its ratings correlate with superior returns for the same risk level. Others focus on measuring a company's environmental or social impact (ISS), transparency and commitment to ESG (Refinitiv), or provide a screen for ESG selection in support of stewardship goals (FTSE Russell).

The final scores are typically derived by evaluating all three pillars of ESG and looking at specific factors contributing to the individual performance of each component. These could be determined through statistical analysis of past data to recognise E, S, and G drivers, or they might be hypothesised based on a theoretically proposed connection that remains untested.

For example, Refinitiv's ESG score covers the following E, S and G factors:

Environmental

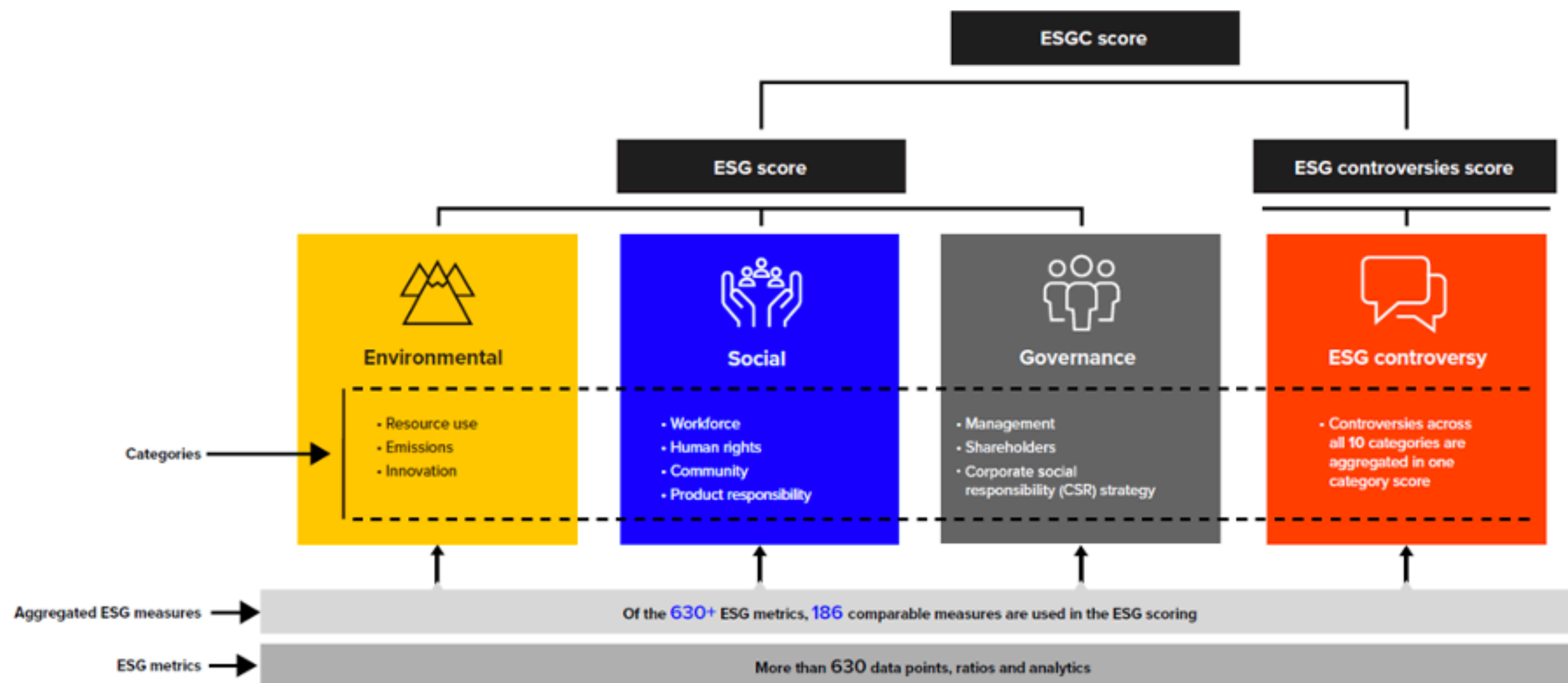
- Resource use
- Emissions
- Innovation

Social

- Workforce
- Human rights
- Community
- Product responsibility

Governance

- Management
- Shareholders
- Corporate social responsibility (CSR) strategy



Source: Refinitiv

Why ESG matters. Read blog >

The challenge of measuring governance

When examining and analysing ESG factors, the “G” factor often gets overlooked amid seemingly more pressing environmental and societal issues like climate change. According to a Morningstar Sustainalytics ESG survey of over 500 CSR and sustainability professionals in 2022, nearly half of respondents considered corporate governance as the least important aspect of their ESG efforts. However, recognising governance risks and opportunities is critical in decision-making bearing in mind the fact that namely, poor corporate governance practices lie at the core of some of the world’s biggest corporate scandals - Volkswagen’s emissions tests scandal and Facebook’s misuse of data to name a few. With companies' mistakes coming to light and the growing consciousness of worldwide diversity and income disparity, corporate governance remains a key element of ESG.

But similar to the “E” and “S” angles of the ESG triangle, measuring and evaluating the effectiveness of governance is not an easy task as it usually involves assessing both qualitative and quantitative data.

In the next section, we take a closer look at some of the key challenges associated with measuring corporate governance performance.

Subjectivity

Corporate governance involves a multitude of practices and behaviours that can be quite challenging to quantify. For instance, how can one measure the effectiveness of a board of directors, the quality of leadership, or the strength of a company's ethical culture? These are largely subjective elements that may vary greatly from one observer to another.

A concrete example of this subjectivity can be seen in the governance practices of Goldman Sachs Asset Management. They developed a scorecard system to evaluate companies' governance practices, which includes areas like strategy, capital allocation, and people. This scorecard, however, is inherently subjective as it relies on the judgment of the Goldman Sachs team. The scorecard does not offer a definitive measurement, but rather a subjective assessment, which can differ significantly between observers.

Lack of standardised metrics

Unlike financial performance, which has clear, standardised metrics such as revenue, profit, and earnings per share (EPS), corporate governance lacks universally accepted performance measures. Different rating agencies and research firms use various indicators and weightings, resulting in potential inconsistencies and confusion.

ISS, for example, applies over 4,000 statistical tests linking governance variables to risk and performance measures, while Governance Metrics International employs several hundred governance mechanisms. On the other hand, Audit Integrity uses 200 accounting and governance metrics with 3,500 variables, whereas The Corporate Library relies on qualitative analysis of specific areas like takeover defences and board-level accounting issues. A Stanford study found little correlation between the ratings of these firms and key performance metrics, indicating that these agencies might be measuring disparate aspects of corporate governance or that there's considerable measurement error across firms.

Information asymmetry

Companies typically have more information about their operations and governance practices than outside investors or analysts. This information asymmetry can make it challenging to assess governance quality accurately. While regulations require certain disclosures, these may not provide a complete picture of a company's governance.

An example of information asymmetry can be seen in South Africa's biggest accounting fraud scandal to date at Steinhoff International. Steinhoff, a company listed on the Johannesburg and Frankfurt Stock Exchanges, was implicated in a major accounting fraud in 2017, including an overstatement of its financial status. With a primary listing in Frankfurt and an Amsterdam corporate address, the company adheres to the Dutch corporate governance code and has been operating under a two-tier board structure consisting of a management board of four executives and a supervisory board of nine non-executive directors. Prevalent in Western Europe, this structure was generally designed to keep the supervisory board independent of the management board and maintain accountability to the shareholders.

But in Steinhoff’s case, the two-tier structure appeared to be one of the reasons for its fall. Inherent flaws in the organisation structure like the management board not keeping the supervisory board constantly in the loop, along with Steinhoff's corporate culture anchored by a dominant personality in the face of its ex-CEO Markus Jooste, seem to have created accountability gaps.

The two-tier structure is often criticised for information asymmetry as it can cause operational issues to develop unnoticed due to the management board's superior knowledge of the business compared to the supervisory board. In 2016, Steinhoff had a management board consisting of three members - CEO Markus Jooste, CFO Ben La Grange, and COO Danie Van Der Merwe, none of whom sat on the supervisory board.

Some analysts also cite the two-tier system, coupled with a corporate culture led by dominant personalities, as a contributing factor to another major scandal, the Volkswagen emissions case.

Complexity and interconnectedness

Corporate governance encompasses a wide array of factors, from driving environmental awareness and ethical behaviour, to ensuring effective board composition and executive compensation, to managing risk and shareholder rights. These elements are interconnected and can influence each other in complex ways, making it difficult to isolate and measure individual governance factors.

“Interconnectedness, unpredictability, and uncontrollability are key characteristics of all complex dynamic systems.

In dealing with complexity rather than mechanisms, the aim of science shifts from improving our ability to predict and control to aiming to better understand the dynamics and relationships of the systems we participate in so that our participation can be more appropriate”

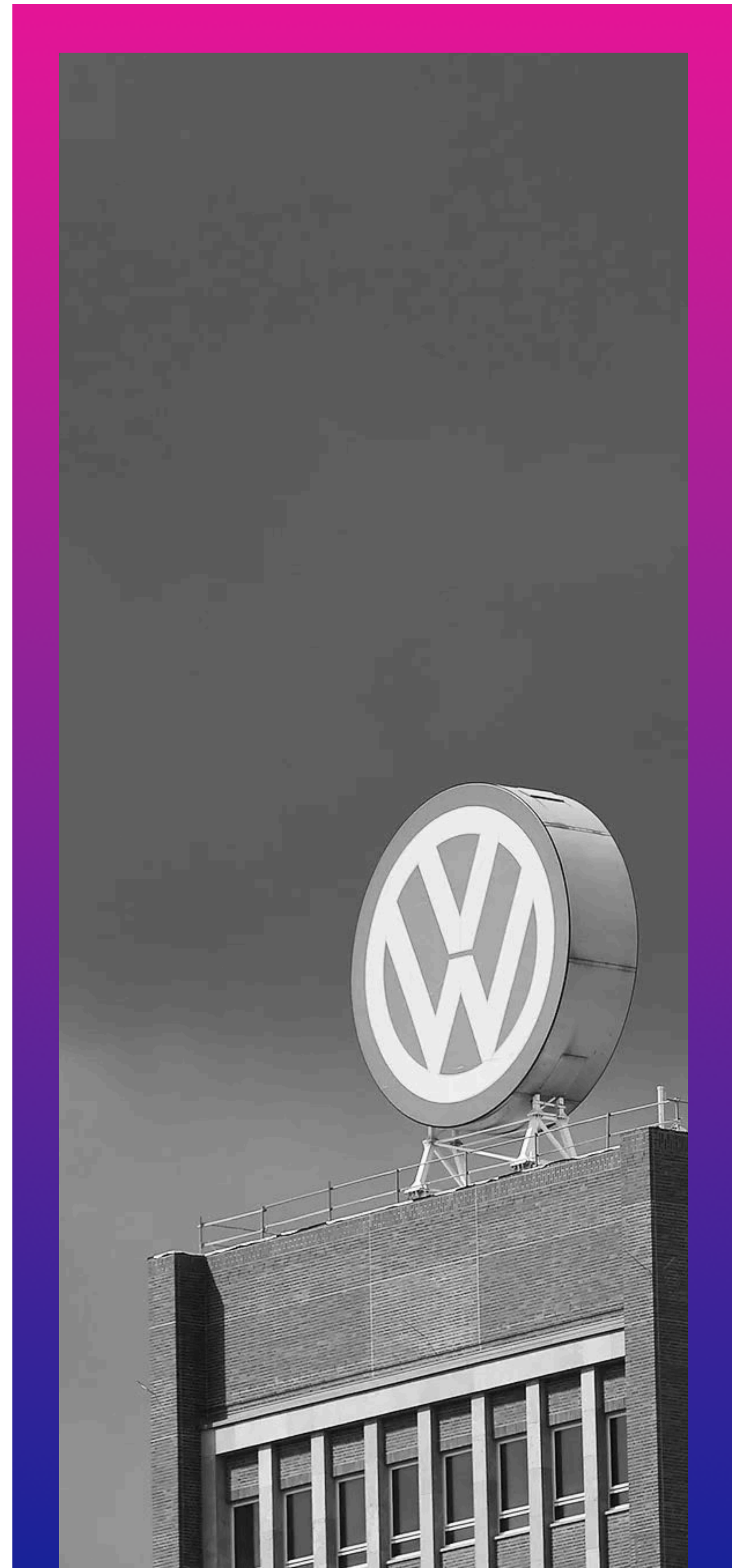
— ***Daniel Wahl, 2019***

Governance: More than just oil in the machine. Read blog >

Long-term effects

The impact of good or bad corporate governance often manifests over the long term, making it difficult to measure in a short-term context. For example, a company may experience financial success despite poor governance due to favourable market conditions, but the inherent risks may lead to serious problems down the line.

A good illustration of the long-term effects of corporate governance is Volkswagen's "Dieselgate" scandal. Despite short-term success, the company's long-term sustainability was jeopardised by poor corporate governance practices. In 2015, it was discovered that Volkswagen had installed software in its diesel vehicles to cheat emissions tests. Initially, the company benefited from increased sales due to the perceived environmental efficiency of its vehicles. However, when the scandal broke, it led to a significant loss of consumer trust, legal penalties, and a decrease in market value, demonstrating how the consequences of poor governance can manifest over the long term.



Addressing the challenge

To overcome the challenges mentioned in the previous section, there is an urgent need for more transparent and standardised reporting of governance practices. Companies worldwide should be encouraged to become more transparent about their governance structures, decision-making processes, risk management strategies, and stakeholder engagement practices. This would enable ESG rating agencies to make more accurate assessments of governance performance.

The demand for global governance standardisation creates a further need for greater international cooperation. This could involve international organisations, governments, and industry associations working together to develop a set of universal criteria and standards for assessing corporate governance performance. Just like the IFRS Foundation has done with the launch of the International Sustainability Standards Board (ISSB) in late 2021 which aims to set up new standards for a global baseline of sustainability disclosures. Another recent example is the ESMA's Call for Evidence (CfE) on integrating sustainability preferences into suitability assessment and product governance arrangements under the Markets in Financial Instruments Directive (MiFID) II launched on 16 June 2023.

Another major issue that needs to be considered is the effective analysis of qualitative data. While quantitative data is important and easier to gather and assess, it may not fully capture the nuances of governance performance. Therefore, ESG rating agencies should put more emphasis on assessing qualitative factors such as the quality of a company's leadership, its corporate culture, and its commitment to ethical practices.

11 steps to facilitate governance performance measurement

In this section, we've outlined 11 key steps companies and their boards and senior management can take to ensure transparency, accountability, and adherence to established guidelines and regulations.

1) Define clear goals and Key Performance Indicators (KPIs)

Establish clear governance goals and KPIs that align with the company's strategy and stakeholders' expectations. The performance indicators may include financial performance, compliance rates, stakeholder engagement, and ethical behaviour.

2) Regular board and executive evaluations

Conduct regular performance evaluations of the board of directors and executive management. The evaluation could assess their decision-making, strategic planning, risk management, and communication with stakeholders.

3) Implement a Balanced Scorecard

This performance management tool can measure financial performance, internal processes, learning and growth, and customer satisfaction. The scorecard can provide a balanced view of the organisation's performance.

4) Use an accountability framework

Establish an accountability framework with a common purpose and clear delegation of authorities or designations of responsibility (i.e. authorised signatories) within the organisation. This can further enhance transparency and minimise the risk of mismanagement and misconduct.

5) Establish governance committees

Set up dedicated committees (like the audit committee, compensation committee, and risk management committee) responsible for specific governance issues. Regular reports from these committees can measure governance performance.

6) Regular reporting and disclosure

Facilitate regular reporting on governance performance to stakeholders. This promotes transparency and can measure the company's adherence to governance norms and principles.

7) Third-party reviews:

Engage external auditors or consultants to review governance procedures and performance. This offers an impartial assessment and can help identify areas of improvement.

8) Employee feedback

Encourage feedback from employees about the company's governance. This can offer unique insights into internal governance procedures.

9) Continuous improvement and training

Regularly review and update governance practices, based on performance measurement results. Invest in governance

training for board members and executives to ensure they understand the latest governance standards and expectations.

10) Use of technology

Leverage technology solutions like governance, risk management, and compliance (GRC) software to measure and monitor governance performance effectively. They can further enhance the adherence to good governance protocols by deploying an authorised signatory management application like Cygnetise which provides a digital solution as an alternative to the paper-based management and distribution of delegated authorities and authorised signatories. Cygnetise allows firms to streamline their operations and improve their governance controls by bringing all their signatory data into one golden source digital repository and unleashing the power of the latest blockchain technology.

11) Ethics and compliance programmes

Establish and measure the performance of ethics and compliance programmes. This can help ensure that the company is adhering to its ethical standards and compliance requirements.

See how Kleinwort Hambros Bank uses Cygnetise >

At Cygnetise, we have developed an application that helps you reduce the risk of fraud, facilitate business continuity and contribute to ESG by digitising the process of authorised signatory management. Our technology enables users to update their lists in real time and has a variety of sharing mechanisms so that the counterpart can always have access to the most up-to-date information without you having to recompile and redistribute.

To learn more about Cygnetise and request a free demo, click here or email our team at info@cygnetise.com

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