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NAVIGATING SUSTAINABILITY ESG RATINGS AND THE ROLE OF REGULATION IN THE EUROPEAN UNION

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CONTENTS

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Abstract

This study provides a comprehensive overview of Sustainable Finance and the significant role of Environmental, Social, and Governance (ESG) rating agencies in shaping modern investment practices. It delves into how these interconnected components impact investment choices and promote sustainable economic practices on a global scale. The focus is primarily on the challenges presented by the variety of methodologies used by ESG rating agencies, which frequently lead to discrepancies in scores and make it difficult for investors to conduct dependable sustainability evaluations. The European Union plays a crucial role in promoting collaboration with stakeholders to improve transparency and reliability in ESG ratings. Efforts to standardize ESG reporting frameworks and methodologies through regulatory initiatives are being evaluated for their potential to effectively tackle these challenges. The publication supports the implementation of strong regulatory frameworks that promote consistency and comparability of ESG assessments across markets. This is aimed at boosting investor confidence and helping informed decision-making in line with their environmental, social, and governance priorities. This research emphasizes the need for continued dialogue and collaborative efforts to navigate the changing landscape of Sustainable Finance. This is essential to ensure that global economic practices align with long-term sustainability objectives.

Key-words: Sustainable Investments, ESG (Environmental, Social, and Governance), European Union (EU), ESG Ratings

Introduction

This research deals with the theme of sustainable finance, shedding light on the increasingly important role that environmental, social, and governance (ESG) factors are acquiring in the realm of investments. As Refinitiv (LSEG Data & Analytics) [2] rightly points out:

"In today's world of globalization and interdependence and in times of financial crisis, issues such as climate change, biodiversity, human rights, 'license to operate', business ethics and corporate governance are at the forefront of public and political attention. How companies respond to these issues is becoming as important as traditional financial metrics when evaluating corporate performance, therefore playing a more central role in investors' decision-making efforts to identify long-term opportunities and risks for companies".

This statement is confirmed by some relevant statistics. The ESG market has experienced exponential growth, reaching an impressive $41 trillion by the end of 2022, as investors increasingly consider non-financial factors when making investment decisions. According to Bloomberg Intelligence, the total assets under management in ESG-related funds have grown from $22.8 trillion in 2016, and it is estimated that ESG-related investments will surpass $50 trillion by 2025 [50]. Specifically, Europe leads the way in ESG investing, with 83% of the total ESG assets under management, amounting to over $2 trillion. This represents a significant increase from previous years, as European investors have become more focused on ESG factors in their investment approach. According to a Capital Group report, 31% of European investors consider ESG to be a central aspect of their investment strategy, compared to just 18% of investors in North America. In the fourth quarter of 2022 alone, Europe saw $40 billion of capital inflows in ESG funds, while the US experienced $6.2 billion of outflows. Notably, only 6% of investors in Europe remain skeptical about ESG investing, compared to 20% of investors in North America [50].

In the first chapter, we set out to establish a foundational understanding of Sustainable Finance and ESG investing. We explore how companies and investors have increasingly taken on central roles in driving global sustainability efforts throughout different eras. Furthermore, we delve into the European Union's strategic initiatives aimed at enhancing the contributions of economic actors to sustainable development. By examining these topics, we uncover the transformative impact of ESG principles on global financial practices and the broader sustainability movement.

In Chapter 2, we build upon this foundation by addressing a fundamental question: How can investors effectively identify companies worthy of their support? We explore the critical role of ESG rating agencies in providing essential evaluations that empower investors to make informed decisions. Central to this discussion is the EU's proactive stance in advocating for standardized and transparent methodologies among ESG rating providers. By promoting reliability and comparability in ESG scores, the EU aims to facilitate sustainable investment choices that align with investors' environmental, social, and governance objectives.

In the last chapter, our focus shifts to a visual demonstration of the impact of the diverse methodologies used by ESG rating agencies. We illustrate how variations in ESG scores can pose challenges for investors evaluating companies for investment opportunities. Using the Stoxx Europe Large 200 Price Index as a backdrop, we compare ESG scores from Bloomberg and Refinitiv, highlighting both global ESG ratings and assessments across environmental, social, and governance pillars. This comparative analysis underscores the complexities and implications of ESG assessments in investment decision-making, underscoring the need for greater consistency and transparency within the ESG rating sector.

Chapter 1
Foundations of Sustainable Finance

The objective of this chapter is to provide a comprehensive framework for understanding ESG criteria and the emergence of the concept of Sustainable Finance. We will explore how, over different eras, companies and investors have taken on an increasingly central role in driving the creation of a greener and more sustainable world. Furthermore, this chapter will delve into the pivotal and expanding role that the European Union is assigning to these economic actors, highlighting the policies and initiatives designed to enhance their contributions to sustainable development. Through this examination, we aim to elucidate the transformative impact of ESG principles on global financial practices and the broader movement towards sustainability.

1.1 The Origins of Sustainable Finance

1.1.1 Positive and negative externalities

Public opinion is paying increasing attention to environmental and social issues: as Beltratti rightly points out [4], "financial investments are an activity of central importance in the overall signal-generating mechanism that aims to steer the management of companies towards models" that minimise the negative effects of their operations (such as, for example, pollution), and maximise "positive impacts on society".

In this context, I think that it is crucial to mention the concept of externality: "externalities generated by the operation of economic activity, [...] have always been at the centre of academic debate" [4]. We are used to identifying two categories of externalities:

- *Positive externalities*, which occur when there is a benefit for society: for example, Research and Development (R&D) carried out by a company can "increase the general level of knowledge within a society" [35];
- *Negative externalities*, which happen when the result is a cost for society as a whole: a clear example of this is the quality of water drunk by people living near a river polluted by a factory's production [4].

What can companies do to manage negative externalities? This topic has always been at the centre of academic debate, long before we might think. Milton Friedman (an American economist, leading exponent of the Chicago School and founder of the Monetarist thought), in an article published in The New York Times in 1970, sets out his thoughts on the subject [31]. The article casts doubt on the very concept of "corporate social responsibility", identifying it as a threat to the basis of a free society. Friedman makes fun of the sweet promises of businessmen, who solemnly talk about the social responsibilities of corporations to the sound of the orchestral anthem. After all, in fact, they preach socialism. Only people can have responsibilities, while corporate executives have an obligation to their owners or shareholders. The author does not stop at the level of platitudes but, on the contrary, asks practical questions. How can the executive know which actions will benefit society? How, therefore, can he decide what to spend on, and what to charge for his social responsibility? The author ends the article by stating that the only real social responsibility of the corporation in a free society is to give profits to the shareholders. It is the power of public policy and regulation that must establish the rules of altruism and charity.

What Friedman outlines in his article is a concept of the enterprise as "*ownership*", i.e. as an isolated entity whose sole responsibility is to act in the interests of the shareholders. Charles Handy (an Irish author and philosopher specialising in organisational behaviour and management) had a completely different opinion on this matter: he suggested that this concept of the enterprise as "ownership" should be dismissed (as a remnant of the 19th century) in favour of a more contemporary one, which perceives the enterprise as "*social entity*" [32]: indeed, in the 21st century, companies interact with the economic and social environment in which they operate. Therefore, we must consider the overall framework of relationships and the vast network of partnerships that the company builds while conducting its business. According to Handy, thinking that "the purpose behind the existence of a company is mere profit is [...] a tragic element of confusion" [32].

These two opposite ways of identifying a company lead us to reflect upon two crucial subject matters: the evolution of the concept of stakeholders, and the notion of Corporate Social Responsibility (CSR).

1.1.2 The concept of Stakeholders

The definition of "stakeholder" has evolved over time to encompass a broader range of individuals with any type of interest in the company and its activity. Initially, stakeholders may have only included customers and suppliers, but now companies also need to consider the interests of their employees, shareholders, financiers, and even society as a whole and future generations. Clayton [9] tries to give the simplest definition of stakeholders: "A stakeholder can be an individual or a group, with the word 'anyone' inviting us to draw our net as widely as possible. And any interest means that they can be interested in what you are doing, how you are doing it or its outcome." He explains that the word "stakeholder" first appeared in The Oxford English Dictionary in 1708, meaning “the holder of a wager”, and identifies eight phases of the evolution of the concept. The history of stakeholders traces back to the early 18th century,when a similar concept originated in the gambling culture; later on, it became a crucial element of contemporary management practices. In the late 19th century, the primacy of shareholders dominated business thinking, but in the 1940s managers were perceived as trustees, whose sole task was to balance the interests of different communities. The formal acknowledgement of the term “stakeholder” emerged in the early 1960s, and Igor Ansoff included stakeholding into corporate strategy in the late 1960s. The stakeholder theory emerged in the early 1980s with Robert Edward Freeman, who emphasized the need to consider a range of stakeholders in corporate decision-making. The concept of “stakeholder economics” was introduced by Prime Minister Tony Blair in the mid- 1990s: he pointed out the relevance of stakeholders in the social and economic spheres. In the 2010s, Stakeholder Engagement emerged as a business discipline, stressing the need for companies to actively engage stakeholders for long-term success.

The message that the article wants to convey is that *understanding stakeholders* is fundamental for strategic decision-making as it creates a collaborative and inclusive approach to project management, leading to better outcomes and stakeholder satisfaction. In Figure 1.1, I have summarized some of the benefits that learning about stakeholders brings to the firm’s business.

1.1.3 Corporate Social Responsibility

Corporate Social Responsibility (CSR) is defined by the European Commission [49] as follows:

> “Corporate social responsibility is essentially a concept whereby companies decide voluntarily to contribute to a better society and a cleaner environment. [...] Although the prime responsibility of a company is generating profits, companies can at the same time contribute to social and environmental objectives, through integrating corporate social responsibility as a strategic investment into their core business strategy, their management instruments and their operations.”

From these few lines, we can already see an evolution in thinking concerning the idea of social responsibility of firms towards society: the main obligation of companies remains that of generating profits, but the European Commission emphasises that it is essential to recognise CSR as directly linked to the creation of economic value.

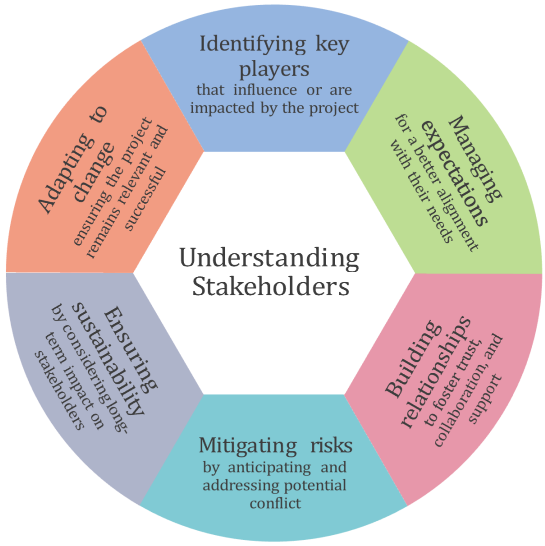


Figure 1.1: Six benefits that understanding stakeholders brings to the firm's business [9], own elaboration.

Traditionally, we can identify four categories of CSR [44]:

- *Environmental* responsibility, which can be pursued by companies in several ways, such as reducing harmful practices, regulating energy consumption, offsetting negative environmental impact;
- *Ethical* responsibility, which makes sure that an entreprise is acting in "a fair and ethical manner" [44], safeguarding the equal treatment of all stakeholders;
- *Philanthropic* responsibility, which is concerned with the broader goal of a company of making the world a better place to live in;
- *Economic* responsibility, which is "the practice of a firm backing all of its financial decisions in its commitment to do good" [44].

Responsible Business Conduct

The concept of Corporate Social Responsibility (CSR) is closely linked to that of Responsible Business Conduct (RBC). The term was first defined by the Organization for Economic Co-operation and Development (OECD) as "making a positive contribution to economic, environmental and social progress with a view to achieving sustainable development and avoiding and addressing adverse impacts related to an enterprise's direct and indirect operations, products or services" [10].

RBC is the first stage of Due Diligence (also known as "supply chain responsibility"), which is defined by the OECD Guidelines as "a continuous process to help enterprises identify risks relating to human rights, labour rights and the environment with a view to ending, preventing or mitigating those risks" [41]. So, due diligence is an ongoing series of actions to accomplish a precise goal: "avoid causing or contributing to adverse impacts on people, the environment and society, and to seek to prevent adverse impacts directly linked to operations, products or services through business relationships" [41]. When these harmful effects cannot be avoided, firms should use due diligence to have the necessary tools to reduce them. The due diligence process is made up of six stages, which are represented in Figure 1.2.

Why are Corporate Social Responsibility and Responsible Business Conduct important? [10]

- For firms, because they "provide important benefits in terms of risk management, cost savings, access to capital, customer relationships, HR management, sustainability of operations, ability to innovate and eventually profit" [10];
- For the European Union economy, which becomes more sustainable thanks to more innovative and green companies;
- For society as a whole, that grows into an increasingly connected community on the basis of which "the transition to a sustainable economic system" [10] is feasible.

Business and Human Rights

Since we mentioned the existence of the Ethical sphere of Corporate Social Responsibility, we must briefly address the role of human rights in business. Nowadays, companies are global, and they impact human rights wherever and however they operate [3]. The UN defines human rights as follows:

> "Human rights are rights inherent to all human beings, regardless of race, sex, nationality, ethnicity, language, religion, or any other status. Human rights include the right to life and liberty, freedom from slavery and torture, freedom of opinion and expression, the right to work and education, and many more. Everyone is entitled to these rights, without discrimination" [40].

Companies often operate in poor or post-conflict countries, or even in countries where the local government is incapable or unwilling to enforce its own laws [3]. As a consequence, it is challenging to determine who is responsible for preventing companies from violating human rights. To answer this question, in 2011, the United Nations issued a set of principles (The UN Guiding Principles on Business and Human Rights – UNGPs) that define the responsibilities of governments and businesses. These principles were included by the European Union in its 2015 and 2020 action plans on human rights and democracy [10].

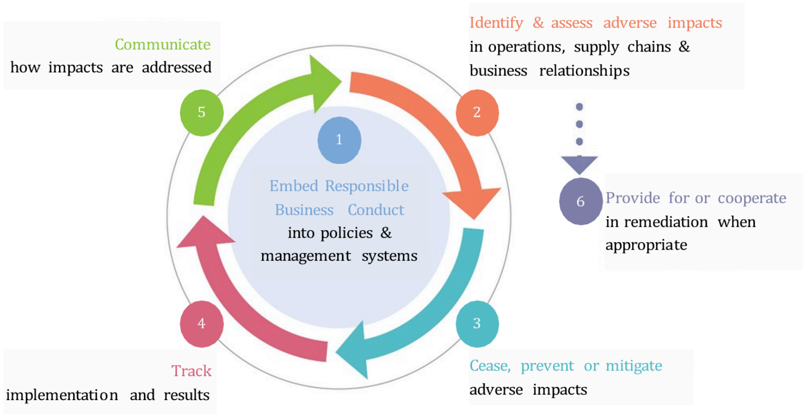


Figure 1.2: Due Diligence Process & Supporting Measures [41].

The 31 Guiding Principles are based on three pillars, which are summarised in Figure 1.3.

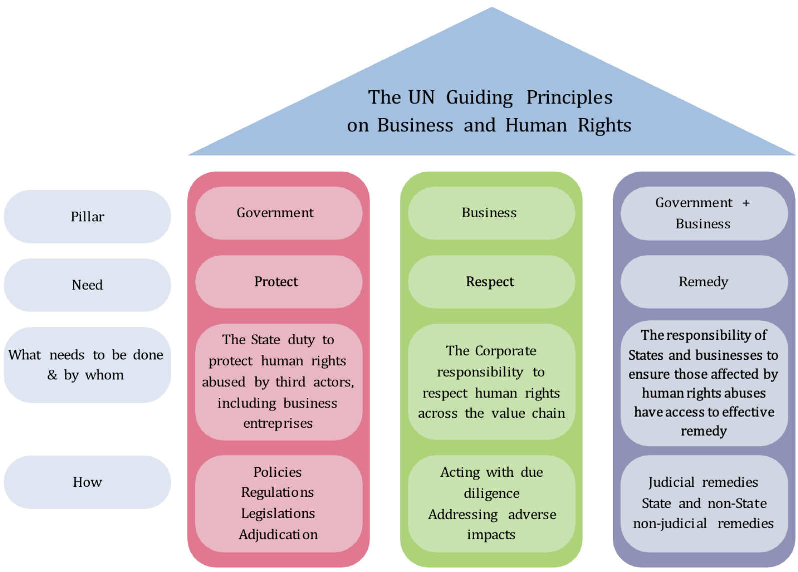


Figure 1.3: UN Guiding Principles on Business and Human Rights - schematic overview [16], [45], own elaboration.

1.1.4 SRI/ESG Investing

Financial investors became an increasingly important component of the community [4]: through impact investing, these economic actors can support companies and organizations that promote social innovation, wellness, and environmental responsibility, or divest from those that carry out practices contradicting their beliefs [42]. In the 1960s and 1970s, the concept of *Socially Responsible Investing* (SRI) was developed as people began to consider the non-monetary impacts of their choices [4]. In particular, in 1971, we witnessed the creation of the Pax World Fund, the first public mutual fund in the United States to consider social and environmental criteria in investment decisions [36]. This was one of the earliest examples of SRI, but it would take decades before we would see such actions "formalised into specific rules and practices" [36]. This would eventually lead to the birth of the framework now known as Environmental, Social, and Governance (ESG). We could therefore define ESG investing as an enhancement, a sort of refinement and maturation of SRI. However, the former term does not replace the latter: as Beltratti makes clear, "one way of understanding the coexistence and complementarity of SRI and ESG is to consider SRI as a way of using ESG factors within investment strategies, though mainly in such a way as to exclude those securities that are considered most harmful to the community" [4].

1.2 The Sustainable Finance Framework

1.2.1. What is Sustainable Finance?

As we will see, ESG investing is an important part of the Sustainable Finance Framework. Sustainability is a complex topic with multiple legislative interventions along the way. These regulations ask companies to provide evidence regarding environmental and social matters, in order to be monitored and to be in line with the requirements set by the European Commission. Sustainability challenges are becoming more and more a subject of academic and corporate attention, specifically from a European standpoint, since Europe is becoming a frontrunner with regard to environmental, social, and corporate governance policies.

According to the European Commission [12], "Sustainable Finance refers to the process of taking environmental, social and governance (ESG) considerations into account when making investment decisions in the financial sector, leading to more long-term investments in sustainable economic activities and projects".

Considering the Environmental Pillar, we can include the factors of mitigating and adapting to climate change, preserving biodiversity, preventing pollution, and promoting a circular economy. The Social aspects may include problems of inequality, inclusivity, employment relationships, investing in people and their skills, communities, and human rights concerns. Truly, well-managed public and private institutions must incorporate social and environmental considerations in their decision-making processes by implementing regulations on management structures, personnel relations, and executive compensation. The EU Sustainable Finance Framework includes six pillars:

- *Corporate disclosure of climate-related information*: Corporations should provide more transparent emissions, practices, and climate-related information to assist investors and promote environmentally friendly actions.
- *EU labels for benchmarks (climate, ESG) and benchmarks' ESG disclosures*: these sustainable finance indices evaluate the ESG performance of a company or benchmark against a set of criteria.
- *Sustainability-related disclosure in the financial services sector* : banking and investment sector entities are required to declare how sustainable their investments are. They must specify the proportion of their sustainable investments, as well as the effect of these on the environment and society.
- *EU taxonomy for sustainable activities*: these criteria define environmentally friendly economic activities and aim to steer investors' funds towards them.
- *European green bond standard*: green bonds require issuers to follow specific rules to fund environmentally friendly projects and prove that the money will be used for sustainable purposes.
- *International Platform on Sustainable Finance*: this is an international organization that gathers policymakers, financial institutions, and stakeholders to share knowledge and develop best practices for sustainable finance.

All these tools make it possible to conduct evaluations of a company that do not strictly relate to their financial performance (clues of which can be found in the documents that make up the company's financial report such as the Balance Sheet, the Income Statement and the Cash Flow Statement). Instead, these analyses consider the company's commitments related to environmental, social, and good governance issues. Why is this important for *investors*? The availability of these data allows economic actors to make informed choices and build a more sustainable future. Moreover, whenever we talk about "sustainability", another aspect comes into play: the long-term perspective. Indeed, investors do not usually stop at the creation of a short-term value, but they are interested in the company's future growth.

1.2.2 Policy making timeline

When talking about ESG and sustainable finance, it is always important to take a close look at the European Union legislation, which is complex and constantly evolving. The following sections will highlight key milestones that have shaped the ESG landscape and the development of sustainable finance, providing a clearer understanding of their origins and progression.

Non-Financial Reporting Directive - NFRD

The starting point of this journey can be traced back to 2014 with the Directive 2014/95/EU, which is also known as the Non-Financial Reporting Directive (NFRD) [24]. It requires public-interest entities (PIEs) with more than 500 employees to include non-financial statements in their annual reports: these accounts should cover environmental, social, and employee issues, respect for all human rights, and anti-corruption and bribery matters. Companies are asked to provide information on business models, policies, outcomes, main risks, and non-financial key performance indicators.

The first goal of NFRD is to enforce *transparency* and *accountability* by making sure that companies give relevant non-financial information in a standardized and comparable way. This directive will be revised in 2020, gathering the opinions of the various stakeholders to improve it on the basis of the issues that are most closely followed by the regulator and the market.

Figure 1.4: The UN Sustainable Development Goals.

The law emphasises the regulator's focus on environmental and social issues, with particular attention on the United Nations' Sustainable Development Goals (Figure 1.4), which seek to promote the achievement of greater equality in 2030. This is a new, broader dimension, to which all companies must refer.Before SDGs, in 2000, The United Nations proposed the Millennium Development Goals (MDGs) (Figure 1.5): "8 goals that UN Member States have agreed to try to achieve by the year 2015. [...] Each MDG has targets set for 2015 and indicators to monitor progress from 1990 levels" [51]. The main goal focuses on the 5 Ps:

- People: the wellbeing of people;
- Planet: protection of Earth's ecosystems;
- Prosperity: continued economic and technological growth;
- Peace: securing peace;
- Partnership: improving international cooperation.

Companies need to move closer to these types of goals.

Figure 1.5: The UN Millennium Development Goals [52].

Paris Agreement

Another fundamental milestone was without a doubt the 2015 Paris Agreement [21]. The main goal of the treaty is intended to help limit the Earth's warming to well below 2 degrees Celsius above pre-industrial levels, as well as reaching out for the lower level of 1.5 degrees Celsius. Countries must indicate their country-specific quantitative level of emissions reduction to be achieved in a long-term perspective and keep revising it at regular times. Moreover, the agreement stresses the financial and technological support to enable developing countries to implement the necessary measures to reduce and cope with the impacts of climate change [21].

European Action Plan

The 2018 European Action Plan is the result of the work of 20 experts who make up the "High-Level Expert Group on Sustainable Finance" (HLEG) and who have generated a series of policy recommendations on sustainable finance. As we read from the European Commission website: "The action plan set out a comprehensive strategy to further connect finance with sustainability" [20]. The ten key actions include:

- establishing (at the European level) a unified system (taxonomy) of activities;
- creating certifications and standards for sustainable financial products (e.g. green bonds);
- promoting investments in sustainable projects (infrastructure);
- integrating sustainability into the provision of investment advice (e.g. by amending MiFID II[1] and IDD[2] and European Securities and Markets Authority – ESMA guidelines);
- developing new sustainability indices and increasing transparency in the construction of benchmarks;
- improving the integration of sustainability metrics into ratings and analyst reports;
- clarifying the obligations of institutional investors and managers regarding sustainability criteria;
- integrating sustainability into prudential requirements;
- strengthening communication on sustainability and the development of accounting standards;
- promoting long-term sustainable corporate governance.

[1] This acronym stands for "Markets in Financial Instruments Directive II" (Directive 2014/65/EU) is aimed at harmonizing regulatory standards across the EU to ensure increased market transparency and to promote competition in financial markets. If these goals already represented the cornerstones of the MiFID (Directive 2004/39/EC), the provisions of this new standard include the enhancement of investor protection. As we read in the document of the European Parliament, "In recent years more investors have become active in the financial markets and are offered an even more complex wide-ranging set of services and instruments. In view of those developments the legal framework of the Union should encompass the full range of investor-oriented activities" [23].

[2] The "Insurance Distribution Directive" (Directive (EU) 2016/97) intends to harmonise national provisions concerning how insurance products are designed and distributed in the EU [25].

These actions can be divided into three categories, as shown in Figure 1.6.

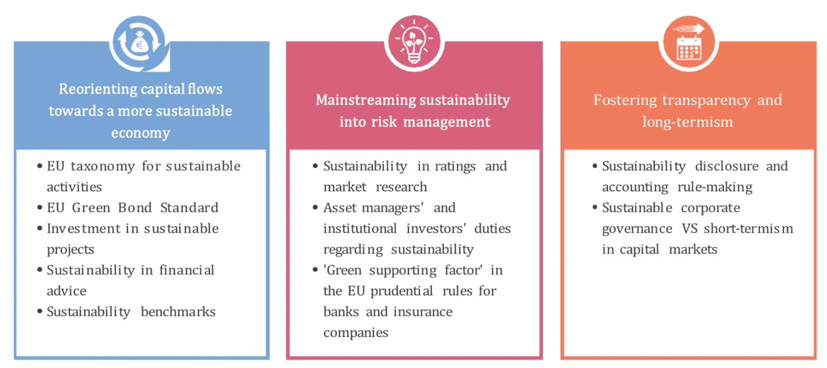


Figure 1.6: Ten key actions of the European Action Plan divided into three categories [20], own elaboration.

Sustainable Financial Disclosure Regulation - SFDR

The Sustainable Finance Disclosure Regulation (SFDR), also known as Regulation 2019/2088 of the European Parliament [27], plays a crucial role in promoting sustainability within the financial services industry in Europe. It sets out transparency requirements for companies offering or advising on products in the EU concerning non ESG aspects. The regulation categorizes financial products into three groups (Figure 1.7):

- *Article 9* refers to investments with a sustainable investment objective;
- *Article 8* concerns investments considering social and/or environmental criteria;
- *Article 6* indicates investments that do not have a sustainable investment objective nor consider ESG criteria.

SFDR's prime objective is to strengthen transparency on ESG issues within the EU and make it easier to compare financial products, ultimately contributing to sustainable finance practices.

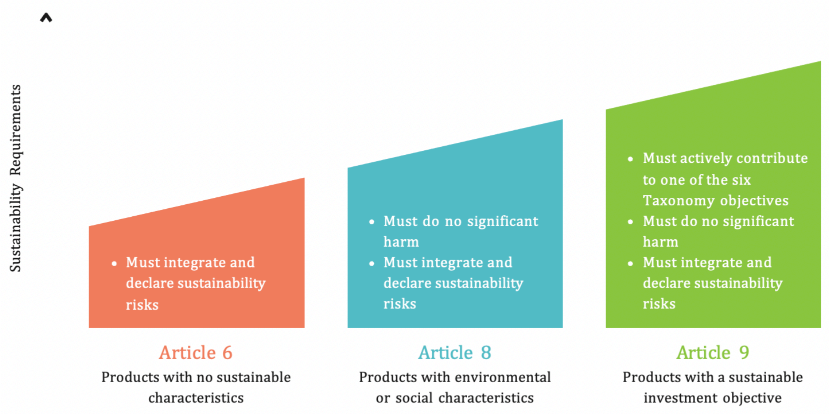


Figure 1.7: Financial product classification in SFDR [8], own elaboration.

So, the SFDR introduces a differentiation, that represents an opportunity for financial products to have a label and be recognised as "green". Investments labelled as *Article 9* generate a strong social and environmental impact: firms that own these types of instruments are social enterprises, which support minorities and less privileged areas. This classification can be used as a litmus test to analyze a company, understanding how it is engaging with sustainability-related issues. Moreover, thanks to this tool, fund managers are able to isolate and select certain equities, building mutual funds to achieve specific ESG goals. In September 2023, there was a revision of the SFDR that had the aim of gathering the views of practitioners on the relevant issues of the Regulation, after the first period of application, including all the insights provided by the Taxonomy Regulation, which added further useful elements for grading financial products according to the labels. In late 2023, the "Final Report on draft Regulatory Technical Standards on the review of PAI and financial product disclosures in the SFDR Delegated Regulation" was published. The SFDR is agreeable at the level of objectives, but the creation of a notable amount of provisions in such a short time made it difficult for firms to metabolise the requirements of the European Union.

Figure 1.8: The main actions of the European Green Deal [14], own elaboration.

European Green Deal

Launched in 2019, the European Green Deal [19] represents a key pillar of the EU's strategy for economic growth as it transitions to a more sustainable and environmentally friendly model. The European Commission presented a comprehensive strategy and policy framework aimed at sustaining the EU economy for the long term. The agreement outlines plans to achieve climate neutrality by 2050, reduce greenhouse gas emissions by at least 55% by 2030 (compared to the 1990 levels), decarbonize the energy sector, promote sustainable agriculture, and preserve biodiversity. It also includes measures to boost the circular economy and make the EU a leader in clean digital technologies. Other actions that are going to be implemented are represented in Figure 1.8. On 10 and 11 December 2020, EU leaders met in Brussels to draw conclusions on the EU's long-term budget for 2021-2027, and on other relevant topics, including the Covid 19 pandemic and the Next Generation EU. When referring to the goals that are expected to be achieved with the European Green Deal, Ursula von der Leyen stated: "Today's agreement [...] gives certainty to investors, to businesses, to public authorities, and to citizens. It future-proofs our Union" [19]. The emphasis that the President of the European Commission placed on the figure of investors confirms, once again, how these agents are becoming fundamental not only in the economic context, but also in the social one, as they assume the role of frontline actors in creating a more sustainable European Union.

Taxonomy Regulation

The Regulation 2020/852, also known as the Taxonomy Regulation, was initially proposed as part of the European Action Plan on Sustainable Finance, and was adopted in June 2020. It was established to facilitate sustainable investments in the European Union, putting emphasis on the importance for the Union's actions to work hand-in- hand with the 2030 Agenda's Sustainable Development Goals (SDGs), crucial in the context of sustainable growth [28].

The Taxonomy is an EU-wide shared classification that sorts economic activities in accordance with their degree of sustainability. The Regulation defines six environmental objectives:

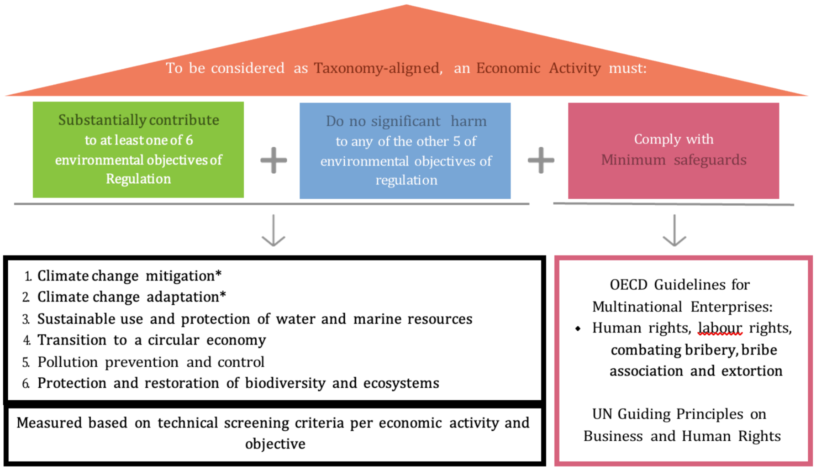
- climate change mitigation;
- climate change adaptation;
- the sustainable use and protection of water and marine resources;
- the transition to a circular economy;
- pollution prevention and control;
- the protection and restoration of biodiversity and ecosystems.

The European Commission is also required to elaborate Technical Screening Criteria (TSC), which "define the specific requirements and thresholds for an activity to be considered as significantly contributing to a sustainability objective" [17]. These TSCs are elaborated in secondary legislation, called Delegated Acts (DAs). The document highlights the importance of providing consistent criteria that allow one to determine whether a specific economic activity is contributing to that objective. A fundamental principle introduced by this regulation is the Do No Significant Harm (DNSH) principle, clarified as follows.

> "One element of the uniform criteria should be to avoid significant harm to any of the environmental objectives set out in this Regulation. This is in order to avoid that investments qualify as environmentally sustainable in cases where the economic activities benefitting from those investments cause harm to the environment to an extent that outweighs their contribution to an environmental objective. Such criteria should take into account the life cycle of the products and services provided by that economic activity in addition to the environmental impact of the economic activity itself, including taking into account evidence from existing life-cycle assessments, in particular by considering their production, use and end of life" [28].

While the Taxonomy is primarily a classification tool, it entails other purposes [17]. The disclosure obligations in this Regulation supplement and amend the rules on sustainability-related disclosures in the EU's NFRD and SFDR, with the goal of improving transparency and providing investors with tools to evaluate sustainable investments [28]. National requirements for marketing financial products should align with the criteria proposed by the Regulation (in order to avoid market fragmentation and protect investors' interests). National competent authorities are empowered to verify compliance with disclosure obligations, must make sure the marketing of financial products aligns with the criteria proposed by the Regulation, and have the power to intervene on misleading practices or sustainability-related information.

In Figure 1.9, we can see a summary of the EU Taxonomy Regulation.



*These two objectives were published in December 2021, and are applicable since January 2022. The others were defined in March 2022

Figure 1.9: Criteria according to which an economic activity is considered compliant [13], own elaboration.

Corporate Sustainability Reporting Directive (CSRD)

If we look at the last steps forward that have been taken by the European Commission, we can see that an attempt is being made to respond to the issue of "greenwashing"[3]. The issue at stake regards finding ways to limit the attempt of some companies or financial products to show themselves as "green" when they are not. A step in this direction was taken with the introduction of the SFRD classification, and since then the analysis of data has been of great help. Many asset management companies had to scale back

[3] "The act of providing the public or investors with misleading or outright false information about the environmental impact of a company's products and operations" [33].

instruments classified as Article 8 as something that was Article 6, since there was no compliance with the criteria that was stated.

Another fundamental law in this context is the Corporate Sustainability Reporting Directive (CSRD, or Directive (EU) 2022/2464), which was proposed in 2021 but came into force on January 1, 2023 (it was then applied on January 1, 2024). Its leading goal is to strengthen the reporting requirements for social and environmental information and to expand the scope of reporting: it includes a broader set of large companies and listed Small and Medium Enterprises (SMEs) [26]. The Directive aims at increasing transparency in the financial market, making sure investors and stakeholders can access essential information to evaluate how a company impacts society and the environment, taking into consideration the financial risks and opportunities arising from several sustainability issues. Companies that are subject to the CSRD are required to report according to the European Sustainability Reporting Standards (ESRS). The Directive also introduces the concept of "double materiality", requiring enterprises to provide information about the impacts of their activities on people and the environment (*impact materiality*) and how sustainability matters affect the firm itself (*financial materiality*). It mandates assurance on the sustainability information that companies report and provides for the digital taxonomy of sustainability information.

European Sustainability Reporting Standards (ESRS)

In July 2023, the EU Commission adopted the delegated act with the first set of European Sustainability Reporting Standards (ESRS) [22]: these principles have been approved and apply from January 1, 2024, as required by the CSRD. As reported in the cited document [22], the objective of ESRS is to indicate the sustainability information that all companies shall disclose about "their material impacts, risks and opportunities in relation to environmental, social, and governance sustainability matters" [22]. In all ESRS, the term "impacts" takes into account both positive and negative actual impacts and potential future impacts connected to a firm's business. These are identified through an impact materiality assessment [22]. The term "risks and opportunities" indicates the financial risks and opportunities that are linked to sustainability topics: these are identified through a financial materiality assessment [22].

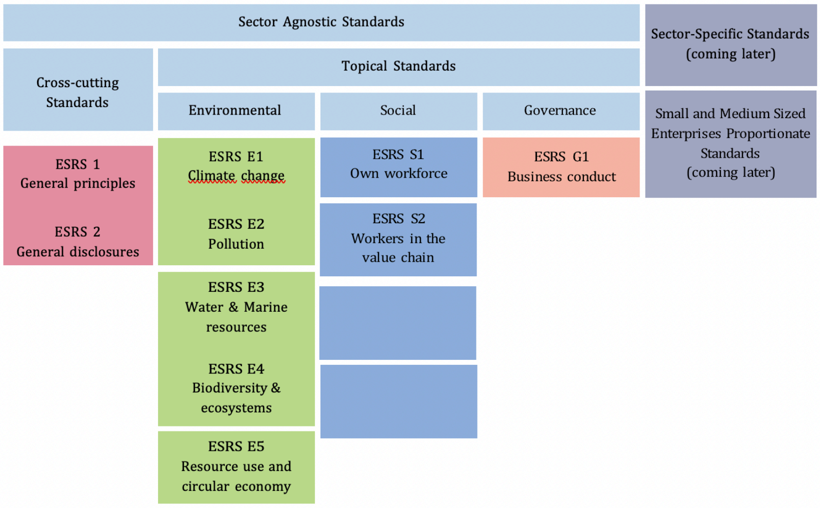


Figure 1.10: European Sustainability Reporting Standards [6], own elaboration.

The ESRS cover a wide range of issues related to sustainability, such as climate change (ESRS E1), biodiversity and ecosystems (ESRS E4), own workforce (ESRS S1), affected communities (ESRS S3), and business conduct (ESRS G1). They are all summarised in Figure 1.10. There are three categories of ESRS: cross-cutting standards; topical standards (Environmental, Social and Governance standards); and sector-specific standards [22]. The first two categories are known as "sector-agnostic", which means they apply to every company, regardless of the sector or sectors in which it operates. The latter are currently under development and are expected to be adopted by June 2026, giving more time to the European Financial Reporting Advisory Group (EFRAG) to elaborate new requirements that will highlight the long-term impact on ESG opportunities and risks. The main aim of ESRS is to provide investors (and other stakeholders) with valuable information to assess the sustainability impact of the companies they invest in, in order for them to make more informed investment decisions and build a more sustainable future.

Figure 1.11 gives a simplified representation of the EU Sustainable Finance timeline.

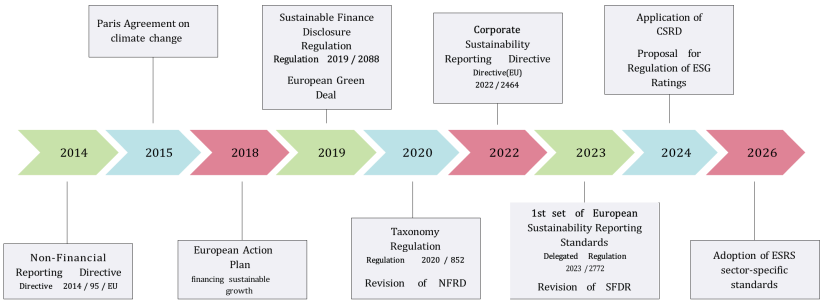


Figure 1.11: Simplified representation of the EU Sustainable Finance timeline, own elaboration.

1.3 Classification Scheme for Sustainable Investments

As we said in the subsection 1.2.1, the concept of Sustainable Finance refers to the application of Environmental, Social, and Governance criteria to investment decisions and, more generally, to all processes that characterise the financial sector. ESG factors have brought about a historic change of direction for the financial universe, involving the concept of stakeholder: these aspects are added to the duties of investment profitability, affecting all areas of finance.

The White Paper published by the European Sustainable Investment Forum (Eurosif) illustrates a classification for sustainable investments. It is intended to "develop a future standard for SRI/ESG related market reports" [7]. The authors point out that this is not a definitive approach, but rather a starting point for elaborating clearer and more complete classification standards. The paper begins by questioning what we actually mean with the term "sustainable investment": different regulatory approaches, such as the SFDR or the MiFID II, propose definitions which may include investments whose active support for the transition to a more sustainable economy is not clear. This fact highlights "the need for a new classification scheme for sustainable investments that has the notion of *transition* at the core of its logic" [7].

1.3.1 Criteria defining the categories

The criteria that are used to define the categories of sustainable investments are summarised in Figure 1.12:

General characteristics explain how much an investment actively operates in order to make the economy more sustainable. The ambition level, the main objective, and the focus on double materiality point out the differences in investments based on their commitment to sustainability.

Pre-investment strategies include approaches that are used before making an investment. These include:

- Exclusions: regards the exclusion of companies whose activities are linked to certain controversial sectors, such as the sale and production of arms, tobacco, alcohol, animal testing, and nuclear energy;
- Norms-based screening: allows to select companies that comply with international norms and standards (e.g. OECD, UN, UNICEF) in terms of environmental protection, human rights, labour standards, and anti-corruption principles;
- ESG integration: a strategy that consists of integrating considerations of ESG risks and opportunities into traditional financial analyses;
- Best-in-Class / Best-in-Universe / Best-in-Progress: allows the selection of companies with the highest ESG score within a group of investees (an industry or a universe). Investees can be selected based on their improvement regarding specific ESG criteria.
- Sustainability-themed: relates to the investment in sustainable topics such as the environment, climate change, ecology or energy efficiency.
- *Post-investment strategies* deal with actions taken after making an investment. Thanks to these approaches, investors become guideposts for companies, allowing them to build a positive relationship that should lead to better corporate governance and more sustainable business models. These encompass:
- Engagement: it can be defined as "a long-term process to influence behaviour of current (potential) investees through interaction with investors (or engagement service providers)" [7];
- Voting: similar to engagement, but in this case the influence is based on ownership rights through voting of shares and other proxies.
- *Performance measurement* aims at assessing how well sustainable investments perform. They usually focus on the effectiveness of investments in achieving sustainability goals.
- *Documentation* involves constructing clear reports including information about sustainable investments. It stresses clear descriptions, outside verification, and disclosure to ensure trustworthy sustainable investment practices.

1.3.2 Five investment categories

Based on these elements, the paper describes five investment categories:

1) *Exclusion-focused investments* have as their primary objective the alignment of portfolios with individual values or norms, and do not include the consideration of financial or double materiality. Because of their low

ambition to contribute to a sustainable transition, they are not classified as sustainable investments. They make use of negative pre-investment strategies to build portfolios that respect specific convictions (e.g., no production of alcohol or tobacco). In this case, performance measurements refer to the violation of values and norms.

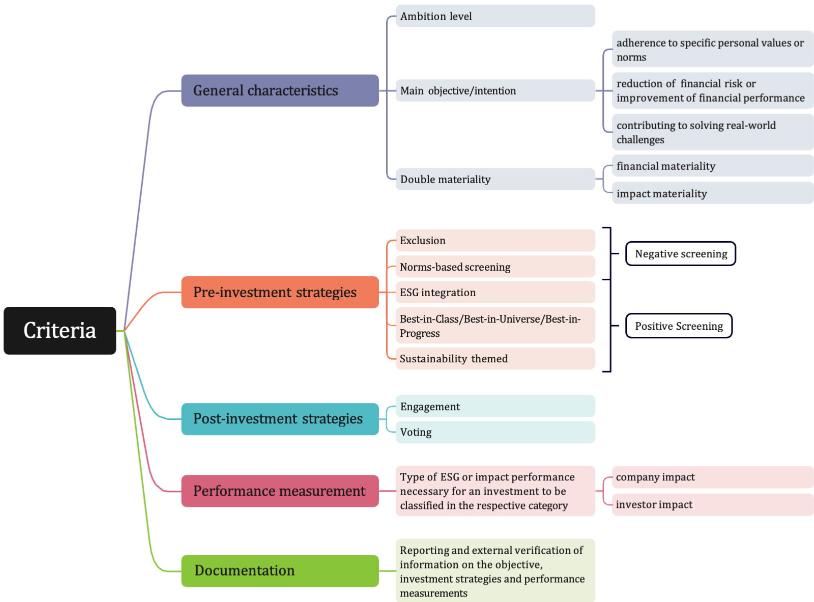


Figure 1.12: Criteria defining the categories [7], own elaboration.

2) *Basic ESG investments* aim at addressing ESG risks and display a moderate level of ambition, as evidence for a positive impact remains speculative. They encompass the examination of the aspects regarding financial materiality, andthey use both negative and positive screenings in pre-investment strategies: the formers are used, for example, to exclude from an investor's portfolio businesses involved in the production of fossil fuels, or CO_2-intensive industries; the latter can be applied to analyze the financially material ESG risks. The performance measurements happens through ESG Key Performance Indicators (KPI) or ESG ratings, while documentation includes disclosing the investment objective and at least one ESG-KPI.
3) *Advanced ESG investments* take a step further by managing ESG risks and opportunities, focusing on financial materiality issues and demonstrating a medium ambition level towards sustainable transition. In contrast to

the Basic ESG investments, they apply stricter rules for positive screening through ESG integration (that is binding), and use post-investment strategies like engaging or voting to collect data and support research. The performance measurement makes use of indicators like ESG-KPIs, Possible Adverse Impacts (PAIs), and ESG ratings. Documentation regards the investment objective and includes a detailed description of pre- and post-investment strategies.

4) *Impact-aligned investments* stand out for their medium ambition level, and their primary goal is to address environmental and social challenges, using double materiality in their analyses. They implement both negative and positive screening, as well as post-investment strategies, in order to intervene on environmental and social issues and, at the same time, support research and improve disclosure. The performance measurement captures the company impact, and makes it easier to identify investees with positive effects. Documentation aims at providing information about the investment objective and the pre- and post-investment approaches that were carried out. Additionally, these reports must include clues about "the positive impact generated by investees and the monitoring process" [7].
5) *Impact-generating investments* are characterised by a strong commitment to actively contribute to solving real-world challenges of social and/or environmental nature, showing a high ambition level and a focus on double materiality. Pre- investment strategies refer to the process of capital allocation as a "mechanism of investor impact to positively influence the impacts of investeees" [7]. Post- investment strategies are mainly used as tools for "investor impact with a clear transition objective" [7]. The performance measurement captures generated ecological and social impacts on company and investor impact. Differently from Impact-aligned investments, their objective is to "actively change investees' impacts through investor activities" [7]. Documentation for this type of investment also needs to provide information about the positive impact brought about by investees and the investor itself and needs to report more than one KPI.

This classification system presents a clear understanding of sustainable investing. It includes different ways and levels of commitment within the sustainable finance scenery, starting from basic risk control to getting involved in a proactive way in sustainable transitions. In the conclusions of the paper, the authors state that the aim of this classification is to "illustrate how investments accelerate the just and sustainable transition of the real economy. As such, it captures the transition contribution of different investment approaches" [7].

In this chapter, we have illustrated the emergence and development of Sustainable Finance and ESG investing, highlighting the growing importance this area of economics has gained over the years. We have seen how investors and companies are having increasingly significant impacts on society as a whole, positioning themselves as key players in the quest for a more sustainable future. The European Union has been striving to keep pace with the rising importance of these actors, actively working to support their efforts in driving sustainability forward.

In the next chapter, we will delve into the role of other critical actors in this process: ESG rating providers. We will examine how these entities can greatly assist investors, who are the drivers of change, by offering clear insights into which companies are better suited for sustainable investment. This will help investors make informed decisions that align with their goals of fostering a more sustainable and responsible economic landscape.

Chapter 2
ESG Ratings Agencies Landscape

In Chapter 1, we discussed the origins of Sustainable Finance and ESG investing, establishing a foundational understanding of these concepts. The classification framework presented by Eurosif offers a starting point for identifying and categorizing sustainable investments based on their contributions to sustainable transition. Now, we must ask ourselves a fundamental question: How can investors concretely determine which companies are better to support and which ones should be avoided?

To answer this question, we need to explore the crucial role of ESG rating agencies, which provide essential evaluations that guide investors towards making informed decisions. The European Union is playing a crucial role in ensuring that ESG rating providers adopt more standardized and transparent methodologies. By doing so, the Union aims to enhance the reliability and comparability of ESG scores, thereby helping investors confidently identify companies that align with their sustainability goals and avoid those that do not.

2.1 Definitions and overview

2.1.1 Credit Ratings and ESG Ratings

In the contemporary investment landscape, the Environmental, Social, and Governance ratings have proved themselves as one of the most indispensable tools for investors who intend to evaluate the sustainability and ethical operations of a company. This way, ESG Rating Agencies (or Sustainable Rating Agencies) act as Credit Rating Agencies, which evaluate the creditworthiness of corporations, yet their assessment covers the areas of environmental performance, social impact, and corporate governance practices, among many others. We can define a credit rating as a "quantified assessment of a borrower's creditworthiness in general terms or with respect to a particular debt or financial obligation" [34]. There is actually no common or official definition of ESG rating, but we can take as a reference this broad definition: "ESG rating means an opinion regarding an entity, issuer, or debt security's impact on or exposure to ESG factors, alignment with international climatic agreements or sustainability characteristics, issued using a defined ranking system of rating categories" [43]. Similarly to the way conventional investors would depend on credit ratings to measure the default risk of a firm, bringing ESG criteria has the effect of making investors consider factors other than financial metrics. Credit ratings to a large extent look at financial risks, but ESG ratings are much more multi-faceted, reflecting the awareness that environmental and social factors can be very important for a company's long-term financial results. ESG ratings serve as a tool for investors to implement ESG-focused investment strategies. They provide insight into a company's financial health as well as its environmental and social impact. This information helps investors make informed decisions that align with their values and preferences.

Although Credit Ratings and ESG Ratings are both useful tools for investors and other economic actors, there are some differences between them. These divergences are presented in the ESMA Report on Trends, Risks and Vulnerabilities [29]:

- *Nature of Assessment*: Credit Ratings evaluate an entity or instrument's credit- worthiness based on a ranking system, with analyst input and potential qualitative factors. ESG Ratings express opinions about an entity's impact on ESG factors, sustainability alignment, and adherence to international climate agreements; they may not clearly differentiate between ratings and scores[4] and rely on qualitative input due to data limitations;
- *Payment Model*: Historically, Credit Ratings follow the issuer-pays model, where the entity that is being rated pays for the assessment. On the other hand, ESG Ratings typically follow the investor-pays model, where investors pay based on desired product and data access levels;
- *Coverage and Pillars*: Credit Ratings mainly focus on assessing credit risk and likelihood of default for entities or instruments, while ESG Ratings encompass three main pillars - environmental, social, and governance - which are aggregated into a single ESG score for a comprehensive sustainability assessment;
- *Methodologies and Data*: Credit Ratings often utilize financial metrics and historical performance data to evaluate credit risk. On the contrary, ESG ratings incorporate a broader range of nonfinancial metrics related to environmental, social, and governance practices to evaluate sustainability performance.

2.1.2 Types of ESG Ratings

Based on the definitions given by different providers, the European Securities and Markets Authority (ESMA) identifies two categories of ESG Ratings [29]:

[4] There is a difference between Credit Ratings and Credit Scores. Credit Ratings are typically based on more qualitative analysis and expert judgment, whereas Credit Scores are often data-driven and rely on statistical models to determine creditworthiness. Both methods serve to assess credit risk, but differ with respect to the level of subjectivity involved in the analysis and the extent of the assessment [29].

- *ESG risk ratings* measure the exposure of companies to ESG risks and how these risks are addressed. This is the most common form of ESG ratings, and examples of it include MSCI, Sustainalytics, S&P, and FTSE Russell.
- *ESG impact ratings* measure the impact of firms on ESG factors. This category includes rating providers such as Refinitiv, Moody's, ECPI, Sensefolio, and Inrate.

Given that risk ratings and impact ratings are based on similar methodologies and metrics, the dividing line between them may be subtle. Moreover, depending on the goals of the providers, ESG ratings can also be backward-looking or forward-looking. Most ESG ratings are used for corporate issuers, although some providers also rate local governments or countries.

Diversified alternative products are available, from those concentrating on the quantity of data reported by a company (Bloomberg) to those considering the influence of ESG issues on a firm's credit rating (Fitch Ratings). Although such alternative products may not meet conventional ESG rating criteria, they are still able to point out substantial ESG risks that can affect a firm's valuation or viability. Moreover, several ratings focus on some of the three pillars of ESG: this multitude of ratings indicates the diverse range of needs from different client types and ways the information is conveyed. Many asset managers appreciate this diversity, although there is widespread support for greater standardization and transparency in ESG ratings.

2.2 ESG Rating Providers

2.2.1 The role of ESG Rating Agencies

As we mentioned in Section 2.1.1, over the past decade, there has been significant growth in the field of SRI. A variety of economic actors, including investors, shareholders, governments, and firms, are now seeking detailed information that extends beyond just the financial performance of companies: indeed, they are also interested in aspects related to the environment and society, and these have become "part of their competitive strategy" [18]. By using their own research methodologies, ESG rating agencies analyze companies and collect data to evaluate the sustainability performance of an entity. The expertise of these providers has become a primary point of reference for businesses, financial markets, and academia, leading to significant growth in the sustainability rating market.

Another important consequence regards the role that ESG rating agencies assume: in particular, they no longer act just as economic actors, but they become *social actors* in the true meaning of the word, since they "have an impact on the behavior of other social actors in society" [18]. This observation has a fundamental corollary: the trust that society has in companies and rating agencies is greatly influenced by the information these entities make publicly available, so is essential for this information to be accurate and not misleading. Additionally, it is important for society's expectations regarding sustainability and sustainable development to be aligned.

2.2.2 ESG Rating Agency Industry

If this is our starting point, we must ask ourselves if ESG rating providers are truly helping to create a more sustainable world. As we said in Section 2.1.1, there is no official definition of ESG ratings, making it difficult to determine the criteria for an organization to be considered an ESG rating agency [29]. As a consequence, it is hard to estimate the total number of companies active in the market for ESG ratings. Some studies from 2019 and 2020 found around 125-150 ESG rating providers, including 10 to 15 major ones [29]. Considering a broader market, in 2022 Deloitte estimated that there were more than 600 ESG rating agencies, "often issuing different ratings concerning the same entity" [15].

2022 ESMA's Call for Evidence

In order to gain a better understanding of the present structure of the market for ESG rating providers in the European Union, the European Securities and Markets Authority (ESMA) issued a Call for Evidence in February 2022, and presented the findings in a letter to the European Commission in June 2022. The call for evidence entailed three parts [43]:

- The first part searched for data directly from ESG rating providers in order to develop an awareness of some specific features such as the legal status, the ownership structure, the level of resourcing, and the business model.
- The second part was aimed at gathering information from entities using ESG rating products to determine, on the one hand, "the nature of engagement with ESG rating providers" [43] and, on the other hand, "the characteristics of any contractual arrangements" [43].
- The third and last part is dedicated to entities that are covered (or rated) by ESG rating providers: this has the goal of learning more

about the nature of the interaction with ESG providers and any related cost.

The responses from these three categories of actors provide us with a reliable overview of the main characteristics of the market.

Overview of Findings

The call for evidence received a total of 154 responses from the three categories under investigation. According to the information provided by these actors, the document indicates that there are 59 active ESG rating providers in the European Union, and highlights some key features of the market.

Firstly, the architecture of the industry is divided between a small number of very big non-EU entities and a large number of considerably smaller EU entities (which can be characterised as Small and Medium Enterprises). As stated in the letter, the legal entities of the respondents were distributed among almost half of the member states, but a considerable number of these were bundled only in three member states, as shown in Figure 2.1: Germany, Italy, and France. The predominant business model is investor- pays, but a third of the respondent providers indicated the issuer-pays model as more prevalent for the provision of ESG ratings.

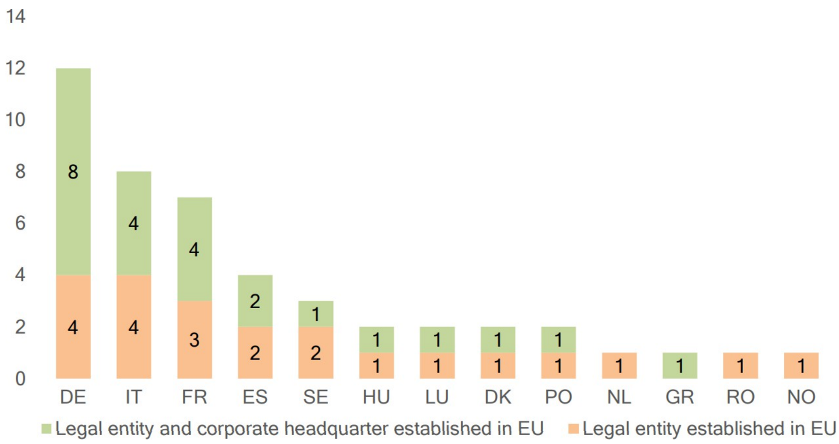


Figure 2.1: Number of respondents with one or more legal entity in EU or with headquarters in the EU, by country [43].

Secondly, the larger part of users of ESG ratings negotiate for these products from several providers at the same time: of the 34 respondents to this question, 77% claimed to rely on more than one provider. The reasons for this choice are mainly to "increase coverage, either by asset class or geographically, or in order to receive different types of ESG assessments" [43]. The most frequently cited ESG rating providers were MSCI (28 mentions), Morningstar/Sustainalytics (25), and ISS (24). This is represented in Figure 2.2. Figure 2.3 displays the estimated investment value for ESG providers based on the usage of their product. There is a certain degree of concentration in the market, as the majority of users contract with a small number of the same rating providers. The most frequent drawbacks recognised by users were "a lack of coverage of a specific industry or a type of entity and insufficient granularity of data" [43], along with "complexity and lack of transparency around methodologies" [43] used by ESG rating providers.

Lastly, entities that are subject to ESG ratings allocate resources to interact with ESG rating providers, with the level of resources depending largely on the size of the rated entity. For what concerns the provision of the ESG rating for their company, these providers were mentioned: MSCI (41 mentions), Moody's/VE (33), ISS (31), Morningstar/Sustainalytics (24), CDP (22), S&P (20), FTSE-Russell (16) and Ecovadis (12). These data are shown in Figure 2.4. However, most respondents noted some limits in their interactions with the rating providers, particularly in terms of transparency regarding the basis for the rating, "the timing of feedback or the correction of errors" [43].

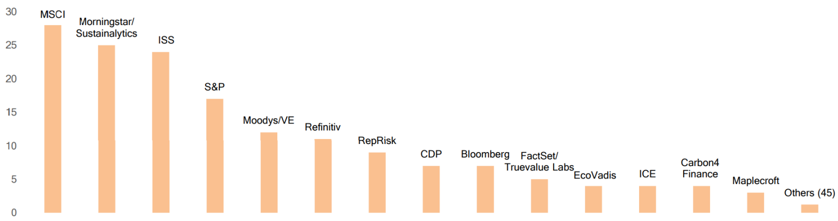


Figure 2.2: ESG providers used by respondents (users of ESG ratings), by count of mentioning [43].

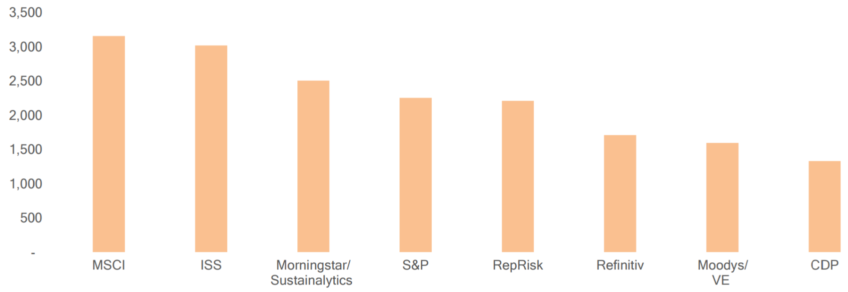


Figure 2.3: ESG providers by estimated investment value for which their product is being used, in EUR bn. Providers below a value of EUR 1 trillion have been excluded for visual purposes [43].

Conclusions

According to the last section of the document, the market structure for ESG rating providers is similar to the existing structure for credit ratings. This means that smaller, more specialized entities from the EU coexist with larger, non-EU entities that offer a more comprehensive range of services. Although the market for ESG rating and data providers is still relatively new, it is growing and has taken this shape after several years of consolidation, a process that will be described in Section 2.2.3.

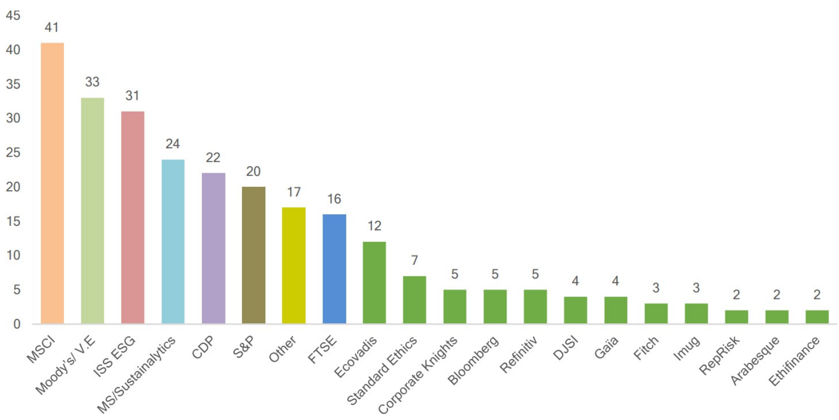


Figure 2.4: Number of covered entities mentioning ESG rating providers (based on 37 responses) [43].

2.2.3 The process of consolidation

In recent years, the industry has undergone a significant consolidation [29]. This has taken place not only through mergers and acquisitions, but also through the entry of new financial rating and information provider agencies [18]. In particular, we notice that this concentration process has occurred from 2008 (with the financial crisis, which "brought about a positive shift in capital market perceptions and attitudes towards corporate sustainability" [18]) to 2018. This process is shown in Figure 2.5 and Figure 2.6.

The main incentives for this growth tend to be financial stakeholders and investment decision-makers [18]. Through this process, ESG rating providers stopped being isolated economic actors to became part and parcel of the financial market. One important example of this was the case of Morgan Stanley Capital International (MSCI) [18]. The company has grown significantly through a series of acquisitions: in 2010, it acquired RiskMetrics Group, which had previously bought ISS, Innovest Strategic Value Advisors, and Kinder Lydenberg Domini (KLD) Research & Analytics. MSCI continued to expand by acquiring MeasureRisk in 2010, Governance Holdings Co. (GMI Ratings) in 2014, and InvestorForce in 2013. This evolution shows how the firm has become a crucial provider of ESG data for institutional investors, with its ESG Research arm supplying the data used to construct the MSCI ESG Indices. In more recent years, we can consider some other industry trends which can, however, always be traced back to processes of concentration. Major players like S&P and Moody's acquired, respectively, the ESG rating arms of RobecoSAM (January 2020) and Vigeo-Eiris (April 2019). Other deals were ISS buying Oekom Research (2018), Morningstar getting Sustainalytics (two phases: 2017, 2020), and the London Stock Exchange Group purchasing Beyond Ratings in 2019 and Refinitiv in late 2021. A 2020 study from the Autorit´e des March´es Financiers (AMF) notes thirty ESG-related mergers and acquisitions since 2009 [29]. Figure 2.7 provides an up-to-date overview of the ESG ratings providers industry.

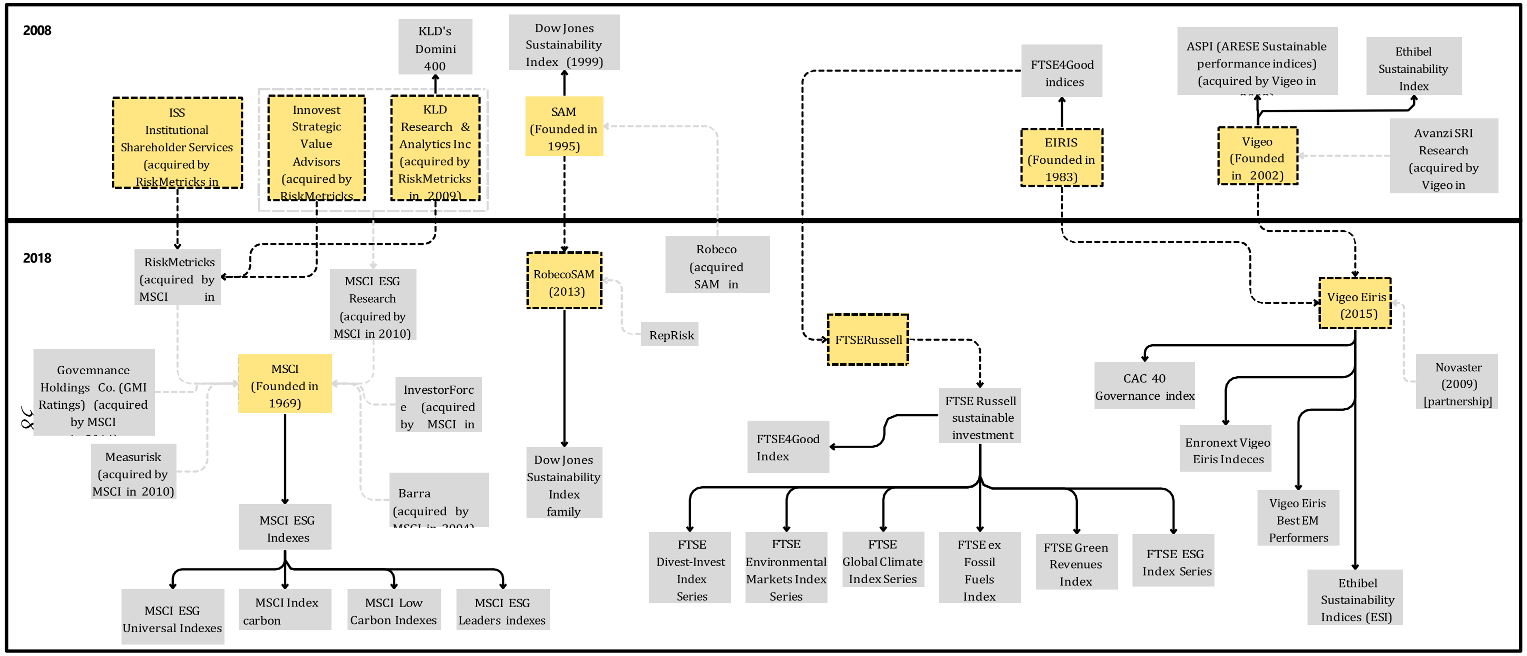


Figure 2.5: The environmental, social and governance (ESG) rating agencies market concentration (1) [18], own elaboration.

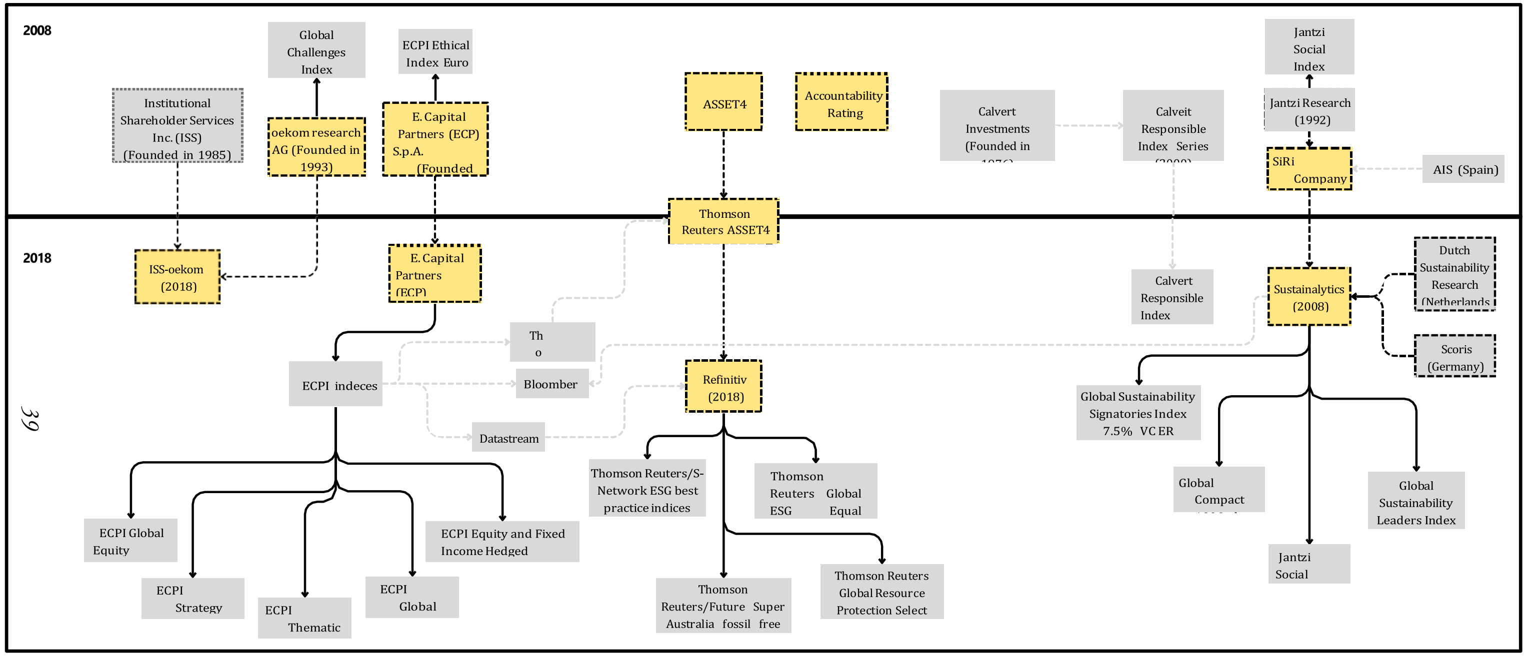


Figure 2.6: The environmental, social and governance (ESG) rating agencies market concentration (2) [18], own elaboration.

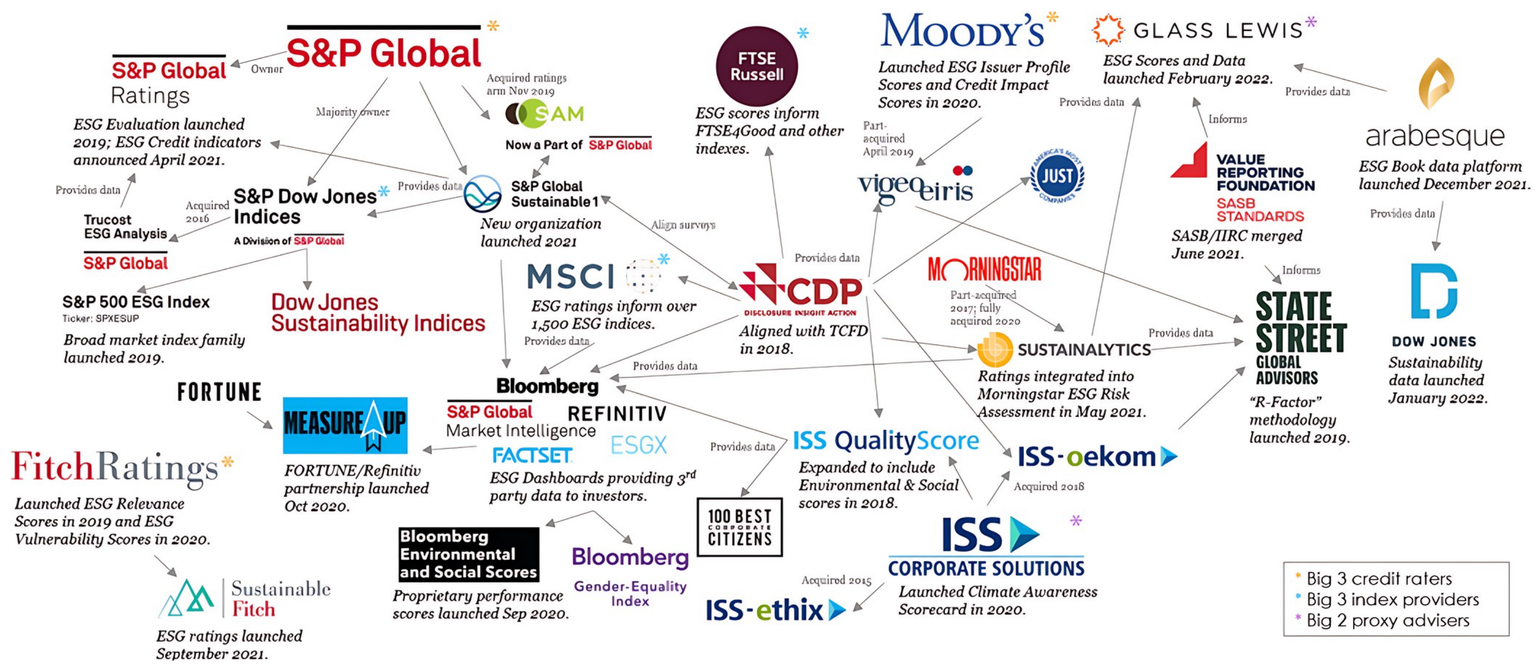


Figure 2.7: Companies face a crowded and confusing landscape of 600+ ratings and rankings [38].

These examples illustrate how a large number of agencies have emerged, while others have disappeared from the market (most frequently taken over by a competitor) [18]. It is possible to observe two distinct strategies [18]:

- *organic growth and partnerships*, establishing a network of alliances;
- *mergers and acquisitions*, that allow two or more ESG rating providers to combine (e.g., Vigeo-Eiris merger in 2016), or when "financial data providers and assessment managers decide to enter into the ESG rating industry " [18].

Sustainability is a multidimensional concept, and the consolidation process of the ESG rating agencies industry has enabled these actors to elaborate a more comprehensive evaluation of corporate sustainability. As Figure 2.5 and Figure 2.6 display, current ESG rating providers have "integrated specialized actors in corporate governance, data management, risk or communication into their systems" [18]. In addition, the market shift has led to the creation of diverse and professional teams that work across sectors and geographies.

2.2.4 ESG rating providers' Methodologies and Classification

Each ESG rating agency uses its own research and sustainability assessment methodology: these different approaches seem to be correlated "to a market-led strategy of differentiation and to cultural and ideological factors" [18]. The larger part of ESG ratings relies on publicly available data (e.g., corporate reports and disclosure), and some providers collect information directly from companies through interviews and questionnaires [29]. Although these evaluation processes are widely varying, some recurring measurement aspects are always taken into account [18]:

- the categories regarding environmental, social, and governance aspects, and the positive criteria included in each of them;
- the controversial practices and activities assessed;
- the normalisation process of the ratings by the industry.

Investors need to ensure that the ratings provider they rely on aligns with their ESG preferences, or else they may end up constructing portfolios that do not match their ESG views. The first crucial step in this process is to categorize the different types of providers accurately [37].

There is no clear-cut, universally accepted classification of ESG rating providers, since it is quite difficult to univocally identify the business in which each of these companies operates. ESMA provided a classification scheme which divides ESG rating agencies into five groups according to their core business area [29]:

- *CRAs*. Several Credit Rating Agencies, including S&P, Moody's, and

Fitch Ratings, have begun to offer ESG ratings alongside their traditional services to their clients.

- *Benchmark administrators*. Some index providers create ESG ratings to build ESG indices, such as MSCI and FTSE Russell.
- *Data vendors*. Data platforms such as Bloomberg and Refinitiv provide ESG ratings to clients, while fund data providers like Morningstar use these ratings to rank funds based on their portfolios.
- *Specialised firms*. There are some specialized firms whose business revolves around ESG risk metrics and analytics, such as RepRisk, Sensefolio, and EcoVadis SAS.
- *Consultancies*. Consultancy firms such as Apex Group and Mercer produce ESG ratings to inform investors on specific aspects or segments of the market, such as unlisted companies and fund investment strategies.

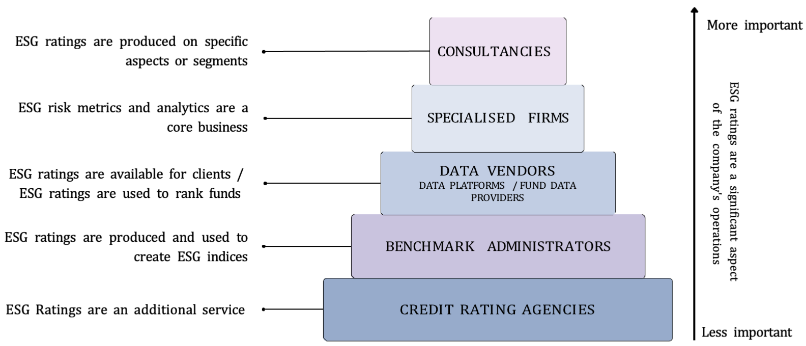


Figure 2.8: ESMA classification of ESG rating providers [29], own elaboration.

According to the article, large conglomerates are consolidating the market by offering a variety of financial data-related services, resulting in some overlapping between these categories. For example, ratings from MSCI and Morningstar Sustainalytics "serve as input to both benchmark indices and fund ESG ratings" [29]. Figure 2.8 illustrates a simplified representation of this classification scheme. Alternatively, providers can be categorized by business model, distinguishing those focused on ESG-related products from those offering non-sustainability-related products.

2.2.5 The challenges of different ESG ratings

The multitude of these rating agencies and the variety of their evaluation methodologies have brought some challenges to be addressed [18]:

- *Lack of transparency*. As we highlighted in Section 2.2.2, ESG rating agencies do not provide complete and transparent information

regarding their criteria for assessing a company's sustainability performance, making it difficult to understand and compare their evaluations.
- *Commensurability*. The lack of consistency between different ESG ratings is due to low commensurability, caused by varying measurement methods used by ESG rating agencies. This prevents the hypothesized benefits of CSR from occurring.
- *Trade-Offs among criteria*. ESG rating methodologies may balance higher scores in one domain with very low scores in another.
- *Lack of an overall score*. Most ESG rating agencies provide scores for each of the three pillars (environmental, social, and governance), but do not calculate an overall score for a company's sustainability performance.
- *Stakeholders' preferences*. ESG rating agencies fail to consider stakeholders' expectations in their assessment methodologies and therefore limit their usefulness and acceptance.

All of these issues contribute to a single overarching problem: it is common for ESG scores from different agencies to vary greatly for the same company. This creates confusion among investors and makes it difficult to interpret and compare the scores. The first point of confusion arises from the different methods providers use to evaluate a company's sustainability performance, as we will see in the following section. As we said in Section 2.1.1, there is no official definition of an ESG rating, which means that sustainability is defined in a subjective way. As a result, this leads to discrepancies in ESG scores. In a paper of 2022, Berg *et al.* [5] investigate the differences in ESG ratings provided by six prominent ESG rating agencies, namely, Kinder, Lydenberg, and Domini (KLD), Sustainalytics, Moody's ESG (Vigeo-Eiris), S&P Global (RobecoSAM), Refinitiv (Asset4), and MSCI. The researchers analyze the rating differences and categorize the methodologies used by each rating agency. They use a common taxonomy of categories to decompose the discrepancy into three contributions: scope, measurement, and weight. This enables them to identify the three sources of discrepancy that contribute to the rating divergence:
- *Scope divergence* occurs when different rating agencies use different sets of attributes to rate entities, causing divergent ratings. For example, one provider "may include lobbying activities, while another might not" [5].
- *Measurement divergence* refers to a scenario where rating agencies assess the same characteristic using different criteria. For instance, a company's labor practices could be assessed based on factors such as "workforce turnover or the number of labor-related court cases" filed against them [5].
- *Weight divergence* emerges when rating agencies assign varying degrees of

importance to different attributes. For instance, the final rating may give more weight to labor practices than to lobbying indicators.

The differences between two ESG ratings are difficult to interpret due to the intertwined contributions of scope, measurement, and weight divergence. Findings show that "measurement contributes 56% of the divergence, scope 38%, and weight 6%" [5]. This causes scorse to be often dispersed and divergent: therefore, investors need to understand which metrics are being assessed to select securities that meet their desired ESG criteria [37].

In conclusion, the field of ESG rating providers is characterized by significant disparities in their methodologies and overall strategies. Each entity employs its own specific techniques for evaluating a company's ESG performance, which includes distinct criteria, data sources, and analytical approaches. These disparities stem from varying interpretations of what constitutes important ESG factors and how they should be measured. As a result, the same company can receive different ESG ratings from different providers, showcasing the subjective nature of ESG assessments. This diversity emphasizes the intricacy of the ESG rating industry and stresses the need for stakeholders to comprehend the underlying methodologies of each provider when interpreting ESG scores. It also highlights the significance of transparency and standardization efforts within the ESG ecosystem to enhance the comparability and dependability of ESG ratings.

2.3 Latest developments of the European Union

2.3.1 Overview of ESG rating activities

The European Union is implementing new regulations on Environmental, Social, and Governance (ESG) ratings to ensure that investors and stakeholders have access to reliable and comparable information about the sustainability performance of companies and financial instruments [11]. ESG ratings assess a company's exposure to sustainability risks and its impact on people and the environment, using terms like ratings, scores, valuations, and opinions. The EU identifies different types of ESG ratings:

- *Aggregated Ratings*: these ratings combine environmental (E), social (S), and governance (G) factors.
- *Individual Factor Ratings*: these ratings focus on specific areas, such as environmental factors.
- *Subfactor Ratings*: these ratings address specific risks, such as climate risks.
- *Materiality Perspectives*:

- Double Materiality: these assessments consider both risks and impacts.
- Single Materiality: these assessments focus on either risks or impacts.

- *International Frameworks*: these use standards like the Sustainable Development Goals (SDGs).
- *Methodologies*:
  - Analyst-Involved Ratings: these include input from rating analysts.
  - Data-Driven Scores: these are based purely on data analysis.

ESG ratings are essential for investors and companies, as they help investors develop sustainable investment strategies by evaluating risks and impacts associated with ESG issues. Moreover, these measures enable companies to manage operational risks, identify investment opportunities, and benchmark their performance against peers. The EU has introduced a new regulation to enhance transparency and reliability in ESG ratings, including:

- *Transparency and Methodologies*: this ensures clear information on ESG ratings' objectives and assessment methodologies.
- *Governance and Independence*: this strengthens the governance of ESG rating providers and ensures their independence.
- *Amendments to SFDR*: this requires financial institutions that develop their own ESG ratings to disclose information similar to specialized ESG rating providers.
- *Authorization and Supervision*: this mandates that ESG rating providers operating in the EU must be authorized and supervised by the European Securities and Markets Authority (ESMA).
- *Conflict of Interest Management* : this clarifies operational standards to prevent and mitigate conflicts of interest.

These measures aim to reduce greenwashing activities and promote sustainable investments. Additionally, these actions are focused on enhancing transparency regarding the impact of companies on people and the environment and fostering investor confidence in sustainable investments. In the next section, we will analyze in detail the new provisions of the European Union on this topic.

2.3.2 Provisional agreement of The Council and European Parliament

On June 13, 2023, the European Commission proposed new regulations for ESG rating activities [30]. The proposal mandates that third-party providers of ESG ratings and scores must be authorized and supervised by the European Securities and Markets Authority (ESMA). The regulation also requires the separation of business operations to prevent and manage conflicts of interest, and establishes proportionate and principle- based organizational requirements. It includes minimum transparency requirements to ensure that the public is informed about rating methodologies and objectives, and that subscribers and rated companies receive more detailed information. Additionally, fees must be transparent, fair, reasonable, and non-discriminatory. Finally, this regulation allows third-country providers to operate in the EU market if they meet criteria for equivalence, endorsement, or recognition.

On February 5, 2024, The Council and European Parliament have reached a provisional agreement on a regulation for ESG rating activities, aiming to enhance investor confidence in sustainable products [30]. As we mentioned before, these ratings play a crucial role in capital markets and investor trust in sustainable products. This new regulation seeks to improve the reliability and comparability of ESG ratings by increasing the transparency and integrity of rating providers' operations and preventing conflicts of interest. The words of the Belgian Minister of Finance, Vincent Van Peteghem, perfectly encapsulate what this regulation represents within the current landscape of ESG rating providers:

"I welcome this agreement. Increasing investor confidence through transparent and regulated ESG ratings can have a significant impact on our transition to a more socially responsible and sustainable future" [30].

Under these new rules, ESG rating providers must obtain authorization and supervision from the ESMA and adhere to transparency requirements regarding their methodologies and information sources. The agreement outlines the scope of the regulation, specifying when ESG ratings are applicable and the territorial boundaries of the regulation within the EU. Financial market participants or advisers who use ESG ratings in marketing communications must disclose the methodologies behind these ratings on their websites, as mandated by an amendment to the Sustainable Finance Disclosure Regulation. The agreement clarifies that ESG ratings cover environmental, social, human rights, or governance factors and allows for separate ratings for each factor. If a single rating is provided, the relative weightings of E, S, and G factors must be clearly stated. EU-based ESG rating providers must obtain authorization from ESMA, while non-EU providers must have their ratings endorsed by an EU-authorized provider, meet quantitative recognition criteria, or be included in the EU registry based on an equivalence decision after discussions between ESMA and the third-country authority. A three-year, lighter, and optional registration option is available for small ESG rating providers. These providers must pay proportionate supervisory fees and adhere to general organizational and governance principles, as well as transparency requirements. They will be subject to the ESMA to request information and conduct inspections. After this period, small providers must fully comply with the regulation's governance and supervisory fee requirements. ESMA may exempt small providers from certain requirements if justified, based on the provider's business nature, scale, complexity,

and range of ESG ratings issued.

The regulation allows ESG rating providers to separate their business activities to avoid conflicts of interest, provided that they implement sufficient measures to manage conflicts. However, this exemption does not apply to providers engaged in consulting, auditing, or credit rating activities. The regulation must be approved by the Council and Parliament before the formal adoption procedure can begin. It will take effect 18 months after its entry into force.

In this chapter, we presented a detailed analysis of the ESG rating providers landscape, examining the market structure, the operational mechanisms of these entities, and their potential to become pivotal references for investors striving to foster a more sustainable financial system and world. Additionally, we highlighted the concerted efforts of the European Union and other European institutions in their collaboration to enhance investor confidence, aiming to improve the reliability and comparability of ESG ratings. Through these initiatives, they are paving the way for a more transparent and accountable framework that supports sustainable investment practices.

In Chapter 3, we will conduct an empirical analysis on a European index to investigate how the differing methodologies of two prominent ESG rating providers, Bloomberg and Refinitiv, can sometimes lead to divergent scores. This analysis will illustrate the challenges and opportunities in standardizing ESG assessments and highlight the EU's efforts to enhance the overall credibility and comparability of sustainable investment metrics.

Chapter 3
An empirical analysis

The primary objective of this chapter is to visually demonstrate how these distinct and sometimes divergent methodologies affect the variation of scores. As we said in Section 2.2.5, this causes problems when investors have to decide whether to invest or not in a certain company.

Specifically, for my analysis, I will start from the Stoxx Europe Large 200 Price Index and compare the ESG scores from two providers: Bloomberg and Refinitiv. These agencies have a similar scoring structure: therefore, they can be easily compared not only with regard to the global ESG score, but also concerning each of the three pillars.

3.1 Stoxx Europe Large 200 Price Index

The Bloomberg Terminal [47] gives this description of the index:

> "The STOXX Europe Large 200 Index is a fixed component index designed to provide a representation of large capitalization companies in Europe. The index is derived from the STOXX Europe 600 Index and covers Austria, Belgium, Denmark, Finland, France, Germany, Greece, Iceland, Ireland, Italy, Luxembourg, the Netherlands, Norway, Portugal, Spain, Sweden, Switzerland and the United Kingdom".

This index is part of the Stoxx Europe 600 Price Index, which comprises 600 companies divided into 200 large, 200 mid, and 200 small stocks. Although the index comprises companies that are not part of the European Union, it remains interesting to analyze how this landscape is evolving. This analysis will also highlight areas where the EU can intervene to drive further improvements.

I have decided to compare the ESG ratings of companies belonging to the Stoxx Europe Large 200 Price Index for my thesis because they are more likely to have established ESG ratings compared to mid-cap or small-cap companies. This means that data regarding ESG should be more readily available for my research. Furthermore, I selected an index of European companies because Europe has been placing a strong emphasis on sustainability and ESG investments for many years now, making it a fertile ground for studying ESG practices.

3.2 Bloomberg and Refinitiv

Bloomberg and Refinitiv evaluate companies according to their overall ESG score and the three pillars of the ESG paradigm, i.e., environmental, social, and governance factors. This approach enables us to analyze and compare the scores of different companies in each category, highlighting the dispersion of scores. These two providers define their scores differently, which adds to the comparison's interest. Here, I have included their score definitions.

3.2.1 Bloomberg's scores

The *BESG ESG Score Percentile* provides a ranking of a company's aggregated ESG performance within its peer group. This percentile ranking illustrates the percentage of scores that are lower than the company's ESG score. By comparing percentiles, users can evaluate the ESG performance of companies across different peer groups. The BESG ESG Score Percentile ranges from 0 to 100, with 100 being the best. Similarly, the *BESG Environmental Pillar Percentile*, *BESG Social Pillar Percentile*, and *BESG Governance Pillar Percentile* provide rankings for each of the ESG pillars. These percentiles allow for comparison of scores across companies within different peer groups and also range from 0 to 100, with 100 being the best.

3.2.2 Refinitiv's scores

Refinitiv *ESG Score* is a comprehensive rating of a company based on its performance in environmental, social, and corporate governance areas. The rating is based on self- reported information and measures a company's ability to act in the best interests of its long-term shareholders by implementing effective management practices and controls. The *Environmental Pillar score* evaluates a company's impact on the natural environment, including air, land, water, and complete ecosystems, by assessing its use of best management practices to avoid environmental risks and capitalize on opportunities. The *Social Pillar score* evaluates a company's ability to build trust and loyalty with its workforce, customers, and society by using best management practices and maintaining a good reputation. The *corporate Governance Pillar score* evaluates a company's ability to manage its rights and responsibilities by creating incentives and checks and balances to generate long-term shareholder value.

3.2.3 Comparison between scores

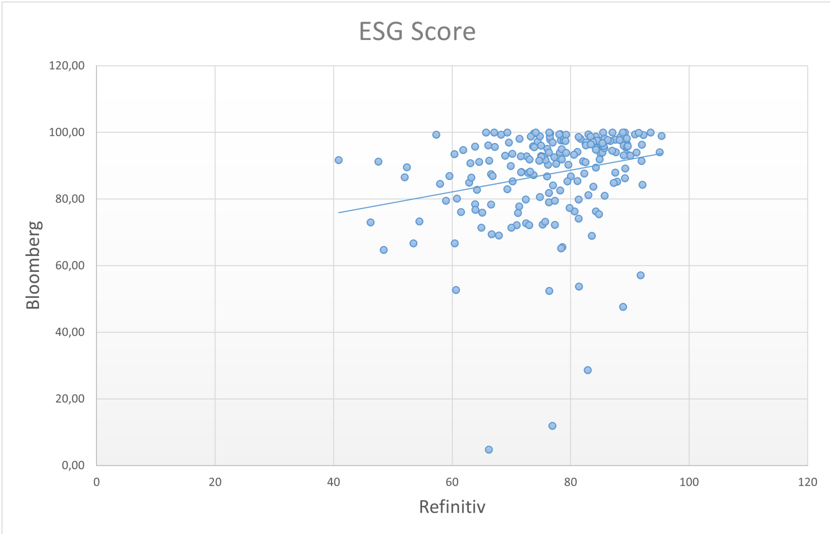
Before discussing the scatter plot graphics, it is important to analyze some descriptive statistics, as shown in Table 3.2. By examining the measures of central tendency, we can observe that Bloomberg, on average, assigns higher scores than Refinitiv, with the exception of the Social Pillar score. Moreover, the median is slightly higher, compared to the mean value, for both Refinitiv and Bloomberg, which is due to the influence of some extreme outliers. Additionally, by looking at the measures of dispersion (standard deviation and sample variance), we can see that Refinitiv has the lowest standard deviation for ESG scores, indicating that individual units' values are close to the center of the distribution. On the other hand, Bloomberg scores have higher standard deviations compared to Refinitiv scores, with the Governance Pillar score showing the highest standard deviation. Looking at the measures of shape, we can gain some insight into the distribution of scores by considering skewness and kurtosis. Skewness is a measure of symmetry, or more precisely, the lack of symmetry of a distribution or data set. Kurtosis, on the other hand, is a measure of whether the data are heavy-tailed or light-tailed relative to a normal distribution. In other words, if these two indices are far from zero, it indicates that the distribution of the variable being analyzed is deviating significantly from a normal distribution. Generally speaking, the negative skewness of scores suggests a left-skewed distribution, meaning that more scores are concentrated on the higher end. We observe that Bloomberg scores exhibit higher values for kurtosis and lower values for skewness, compared to Refinitiv scores. This is particularly true for the ESG score and the Environmental Pillar score, which show the highest values of kurtosis. We can also gain insight into the range of values in the sample by looking at the lowest and highest scores. In particular, we see that Refinitiv scores have a narrower range compared to Bloomberg scores: this point confirms what we have said about form measures of distribution.

Bloomberg and Refinitiv use the same scoring scale, which makes it interesting to analyze the distribution of scores on a scatter plot graph. Refinitiv scores are placed on the x-axis and Bloomberg scores on the y-axis. First, we have to observe the values of R-squared for each of the scatter plot graphs. R-squared is defined as a "statistical measure that determines the proportion of variance in the dependent variable that can be explained by the independent variable" [46]. In our case, the values of R-squared are the following:

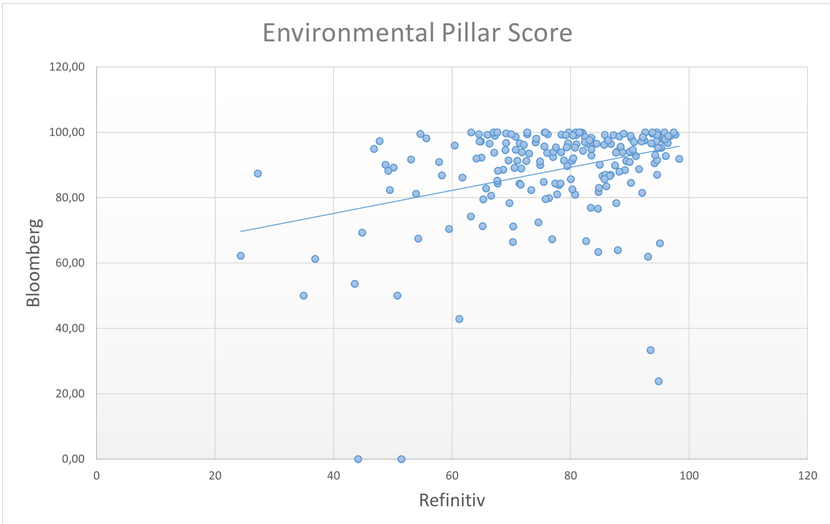
for the ESG score, $R^2 = 0.057$ (Figure 3.1a);
for the Environmental Pillar score, $R^2 = 0.1104$ (Figure 3.1b);
for the Social Pillar score, $R^2 = 0.0498$ (Figure 3.1c);
for the Governance Pillar score, $R^2 = 0.1003$ (Figure 3.1d).

It is evident from the R-squared values that there is a very low correlation between the two scores. However, we can make some comment about the *percentage change between scores*: this value was calculated using the following formula:

$$\%\ \text{Change} = \frac{\text{Bloomberg score} - \text{Refinitiv score}}{\text{Refinitiv score}}$$

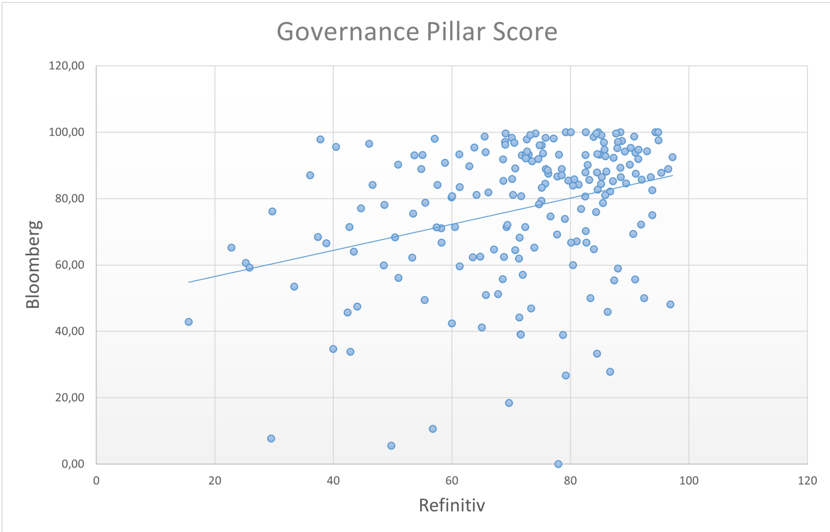


(a) ESG scores.

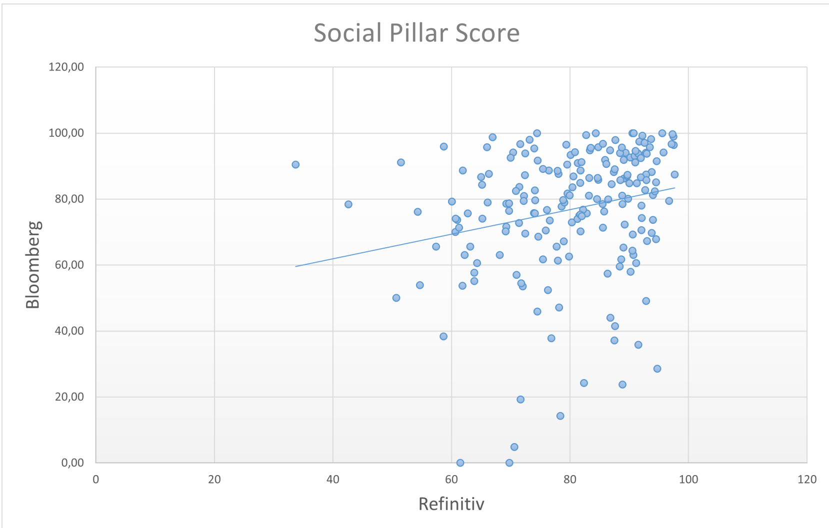


(b) Environmental Pillar scores.

Figure 3.1: Comparison between different scores of Refinitiv and Bloomberg. Own elaboration (Data Source: Refinitiv and Bloomberg).



(c)Social Pillar scores.



(d) Governance Pillar scores.

Figure 3.1: Comparison between different scores of Refinitiv and Bloomberg. Own elaboration (Data Source: Refinitiv and Bloomberg) (cont.).

Following this calculation, eight classes were established, each representing a range of percentage change: these clusters are displayed in Table 3.1. In an ideal scenario, we would expect to see more companies in the initial classes, which are linked to a lower variation between scores, and a decreasing number of firms in those clusters associated with a greater divergence of ratings. This pattern is generally observed for both the total ESG score and the individual pillar scores: indeed, most companies can be found within a percentage variation range between 0% and 40%. This is a significantly positive outcome, especially considering that Bloomberg and Refinitiv construct their scores using very different methodologies. In particular, it seems that the ratings concerning social issues are most closely aligned between the two providers, as most companies fall into the top three categories. Nonetheless, we must also notice that for the single pillar scores, compared to the total ESG score, there is an increase in the number of companies in the last class, where the rating varies by more than 100%. This is especially true for the Governance score, which has the highest number of companies with a percentage change between scores exceeding 100%. Additionally, this pillar displays more homogeneous clusters, indicating that many companies have ratings that differ from each other by a percentage higher than 40%.

The differences in the criteria evaluated by Bloomberg and Refinitiv could be the reason for the significant difference in ratings provided by the two agencies. However, as we previously discussed in Section 2.2.5 when mentioning Berg *et al.*'s study, it is challenging to ascertain whether the discrepancy in scores is a result of scope divergence (due to providers employing a distinct set of attributes), measurement divergence (linked to providers evaluating the same characteristics using different criteria), or weight divergence (because rating agencies allocate varying levels of importance to different attributes), as the effects of these divergences are closely connected and intertwined.

Class of % change	Number of units			
	ESG	ENV	SOC	GOV
0% - 10%	60	70	85	59
10% - 20%	51	37	48	38
20% - 30%	37	33	22	33
30% - 40%	24	20	18	16
40% - 50%	11	11	6	15
50% - 70%	6	11	6	13
70% - 100%	5	7	9	12
>100%	1	4	1	9

Table 3.1: Clusters of the percentage change between Bloomberg and Refinitiv scores and number of units associated to the global ESG score (ESG), the Environmental Pillar score (ENV), the Social Pillar score (SOC), and the Governance Pillar score (GOV). The total number of firms for each score may vary as some firms have both Refinitiv and Bloomberg scores, some have only one, and some have none (Data source: Refinitiv and Bloomberg).

The evaluation of ESG rating providers reveals a substantial degree of methodological diversity, leading to considerable inconsistencies in the ESG ratings assigned to the same company. This observation underscores the intricate and subjective nature of ESG assessments and underscores the significance of comprehending the methodologies of various rating agencies. For stakeholders, possessing this knowledge is crucial when interpreting and comparing ESG scores.

In this context, the European Union plays a pivotal role in addressing these challenges. By advocating for more standardized methodologies and enhancing transparency requirements, the EU aims to mitigate these discrepancies and improve the reliability and comparability of ESG ratings. This approach not only supports informed decision-making among investors, but also fosters greater confidence in sustainable investment practices. Looking ahead, continued collaboration and regulatory advancements within the ESG rating sector will be critical in achieving more consistent and trustworthy evaluations across global markets.

Provider	Score type	Mean	Median	St. Dev.	Sample Var.	Kurtosis	Skewness	Range	Minimum	Maximum
Bloomberg	ESG	87.38	92.20	14.44	208.66	9.63	-2.59	95.20	4.80	100.00
	ENV	88.17	93.25	15.54	241.49	11.64	-2.95	100.00	0.00	100.00
	SOC	76.56	80.50	20.15	406.22	2.78	-1.56	100.00	0.00	100.00
	GOV	76.62	84.10	21.53	463.55	1.43	1.29	100.00	0.00	100.00
Refinitiv	ESG	76.87	78.10	10.42	108.59	0.46	-0.75	54.48	40.85	95.33
	ENV	77.24	79.68	14.61	213.38	0.97	-0.98	73.98	24.33	98.31
	SOC	80.28	81.92	11.82	139.80	0.61	-0.84	63.93	33.73	97.66
	GOV	71.94	74.81	16.94	286.80	0.51	-0.95	81.67	15.60	97.26

Table 3.2: Some descriptive statistics of Bloomberg and Refinitiv scores (Data source: Refinitiv and Bloomberg).

Conclusions

Throughout this study, we have embarked on a journey through the evolving landscape of Sustainable Finance, ESG criteria, and the critical role of ESG rating agencies. We have explored how these elements intersect to guide investment decisions and promote sustainable economic practices. The European Union's proactive stance and collaborative efforts with stakeholders have been central to shaping this narrative.

In Chapter 1, we traced the emergence and growing importance of Sustainable Finance and ESG investing. We observed how investors and companies are increasingly important in driving societal and environmental outcomes. The evolution of ESG and sustainable finance regulations within the European Union reflects a concerted effort to integrate sustainability into financial and economic activities. This process has seen the development and implementation of several key directives, agreements, and initiatives, each contributing to the broader goal of fostering transparency, accountability, and sustainability in the financial sector. In the first chapter, we have described some of the most important achievements in this process.

The first one, the Non-Financial Reporting Directive (NFRD), adopted in 2014, was a significant milestone aimed at enhancing corporate transparency. It mandated large public-interest companies with more than 500 employees to disclose non-financial information related to environmental protection, social responsibility, human rights, anti-corruption, and bribery. The NFRD established a baseline for ESG reporting, making sustainability data available to investors and stakeholders. However, its scope was limited to large public-interest companies, leaving smaller firms without similar obligations, and its flexible reporting standards led to inconsistencies in the quality and comparability of the disclosed information.

The Paris Agreement, adopted in 2015, is an international treaty with the goal of limiting global warming to below 2 degrees Celsius above pre-industrial levels, with an aspirational goal of limiting the increase to 1.5 degrees. This agreement has united countries under a common objective to combat climate change, spurring numerous national and international initiatives and regulations focused on reducing carbon emissions and promoting sustainability. Despite its significance, the voluntary nature of nationally determined contributions (NDCs) and the lack of binding enforcement mechanisms have weakened the agreement's effectiveness. There remains a need for more robust and transparent mechanisms to track and report progress towards NDCs.

Launched in 2018, the European Action Plan on Sustainable Finance aims to reorient capital flows towards sustainable investments, manage financial risks from climate change, and foster transparency and long-termism in financial and economic activities. This comprehensive approach has led to significant legislative proposals, including the Taxonomy Regulation and the Sustainable Finance Disclosure Regulation (SFDR). However, implementation across EU member states has been uneven, and there is a need for more guidance and support to ensure consistent application and clarity in some aspects of the action plan.

The SFDR (effective from March 2021) requires financial market participants and advisors to disclose how they integrate sustainability risks and opportunities into their investment decisions and advisory processes. This regulation enhances transparency and helps prevent greenwashing by standardizing sustainability disclosures, empowering investors to make more informed decisions. However, challenges related to the clarity and consistency of reporting requirements persist, highlighting the need of more precise guidelines to ensure uniformity in disclosures.

The European Green Deal, announced in 2019, is a comprehensive set of policy initiatives aimed at making the EU climate-neutral by 2050. It encompasses various sectors, including energy, agriculture, industry, and transport, promoting sustainable practices and reducing greenhouse gas emissions. The Green Deal has significantly raised the EU's climate ambitions, leading to the introduction of new legislative proposals and financial mechanisms to support green initiatives. However, achieving these ambitious targets requires substantial financial investments and political will, along with more detailed roadmaps and implementation plans.

The Taxonomy Regulation establishes a classification system to determine whether an economic activity is environmentally sustainable. It was adopted in 2020, and it provides much-needed clarity and a standardized approach to identifying sustainable activities, aiding investors and companies in aligning with environmental objectives. Nonetheless, the complexity and technical nature of the criteria can pose implementation challenges for companies, necessitating continuous updates and expansions to cover more sectors comprehensively.

The Corporate Sustainability Reporting Directive (CSRD) was proposed in 2021 to replace the NFRD. The primary objective of this regulation is to extend the scope of sustainability reporting to all large companies and those listed on regulated markets. It introduces more detailed reporting requirements and ensures that reported information is audited and digitally accessible. The CSRD addresses many limitations of the NFRD by expanding the scope and introducing more rigorous and standardized reporting requirements, enhancing the reliability and comparability of sustainability data. However, implementation will require significant efforts from companies to adapt to the new requirements, with necessary support and clear guidance to facilitate a smooth transition.

Developed by the European Financial Reporting Advisory Group (EFRAG), the European Sustainability Reporting Standards (ESRS) will set detailed sustainability reporting standards for companies under the CSRD. These standards aim to ensure consistent and high-quality sustainability disclosures, aligned with international standards, thereby enhancing global comparability. The complexity of the standards, however, may pose implementation challenges for companies, particularly smaller firms. Ongoing support and simplification where possible will be essential to ensure broad compliance.

Despite making significant progress, there are still challenges to overcome, especially in ensuring consistent implementation across member states, simplifying complex requirements, and providing adequate support to companies. Future efforts should concentrate on refining and harmonizing regulations, improving enforcement mechanisms, and continuously updating standards to keep up with evolving sustainability goals and technological advancements. By taking these measures, the EU can enhance its leadership in sustainable finance and contribute to global progress towards a more sustainable and responsive economic future.

Chapter 2 provided a detailed analysis of ESG rating providers, highlighting their potential as crucial resources for sustainable investment. The EU and its partners are working to bring more transparency and accountability to ESG ratings, which will lead to a more informed and responsible investment decision-making process. As these efforts progress, we can expect a future in which sustainability metrics will play a central role in driving positive societal and environmental outcomes within the financial ecosystem. In Chapter 3, our empirical analysis revealed significant methodological diversity among ESG rating agencies, leading to inconsistencies in ESG scores. This underscores the challenges investors face in assessing company sustainability. The European Union's push for standardized methodologies and increased transparency is a crucial step in aligning ESG assessments globally. Moving forward, it is important to have ongoing collaboration and regulatory progress to achieve more consistent and reliable ESG evaluations. This will enable investors to make impactful decisions that support sustainability goals. These efforts pave the way for a future where sustainable finance not only drives economic growth but also promotes lasting social and environmental benefits for future generations

Through continued innovation and global cooperation, the EU is paving the way for a financial landscape where sustainability is not only a goal, but a shared responsibility towards a resilient and equitable future for everyone.

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