

# BRIEFING

## HOW CAN RESPONSIBLE BUSINESSES NAVIGATE ESG?

ESG (Environmental, Social and Governance) has massively increased in popularity in the last decade, with responsible business professionals increasingly called upon to communicate their businesses' purpose and sustainability to investors. But what is ESG, where has it come from, and is it the same as Responsible Business?\*

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The term ESG was first used in a United Nations (UN) report on the Principles for Responsible Investment back in 2006.<sup>i</sup> Fast forward to 2022, and ESG assets are on track to surpass \$41 trillion by 2022 and \$50 trillion by 2025, representing a third of total global assets under management.<sup>ii</sup>

The rapid rise of ESG within the investment community has led to a similar push across the private sector, more generally with 350,000 new ESG jobs created in the UK in 2021<sup>iii</sup> and PwC announcing plans to invest \$12 billion in 100,000 new staff over the next 5 years in a major ESG push.<sup>iv</sup>

However, responsible business and Corporate Social Responsibility (CSR) predates ESG, and CSR professionals are now having to play catch-up with various reporting mechanisms from SASB (Sustainability Accounting Standards Board) to TCFD (Taskforce on Climate-related Financial Disclosures) to ensure that their activities are accurately represented to investors looking for positive ESG scores.

## ESG vs RESPONSIBLE BUSINESS

Responsible business or CSR refers to a self-regulating business model where companies are more conscious of the impact they are having on society.<sup>v</sup>

Business in the Community (BITC) defines a responsible business as 'one that puts creating healthy communities and a healthy environment at the centre of its strategy to achieve long-term value'.

On the other hand, ESG criteria are a set of standards used mainly by investors to evaluate the governance and risk management of a company's social and environmental performance.<sup>vi</sup>

*For more definitions of technical terms and how investment works, read our [Factsheet: An Introduction to Responsible Investment](#).*

## WHILE CSR AIMS TO MAKE A BUSINESS ACCOUNTABLE, ESG CRITERIA MAKE ITS EFFORTS MEASURABLE<sup>vii</sup>

Alva Group



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## WHAT IS ESG?

In its most basic form, ESG is a set of criteria which evaluates companies, such as:

- **Environmental performance** including policies for addressing climate change, protecting nature, and lowering emissions
- **Social performance** including workplace conditions, wellbeing and diversity, and engagement with communities
- **Governance** including pay transparency, integrity in decision-making, diverse leadership, and accountability to shareholders<sup>viii</sup>

Performance against these criteria is then used by investors to guide investment, divestment, and stewardship decisions. Some investors have championed this approach for a long time, such as Federated Hermes that publicly shares information about its ESG engagements<sup>x</sup> and BNP Paribas who recently divested from tobacco in line with its purpose of being 'the bank for a changing world'.<sup>x</sup>

## HOW ARE ESG SCORES CALCULATED?

Investors and financial institutions frequently rely on ratings agencies to measure ESG performance. A ratings agency is a company that assesses the financial strength of companies and government entities.<sup>xi</sup>

Ratings agencies collect and evaluate data, often using in-house statistical models based on market averages and trends. Analysts collect relevant data by analysing corporate disclosures such as sustainability reports and corporate websites, administering surveys, and reviewing information coming from other stakeholders such as regulatory agencies, industry associations and Non-Governmental Organisations (NGO). If there are major events unfolding, they might revise a rating before that, although this is rare. The larger rating agencies and investment firms will also do 1:1 engagement with companies, talk to them about gaps in public reporting and ask what their future strategies look like. Investors then use this information to create ESG funds.

## WHAT ARE THE PROS AND CONS?

The rapid rise of ESG ratings, as well as the relative complexity of the system and language used can make navigating the pros and cons of ESG a minefield for CSR professionals.

### Do they outperform financially?

Recently, ESG has gained more mainstream prominence due to evidence that companies with high ESG scores are outperforming their peers financially.<sup>xii</sup>

However, recent data suggests a more mixed picture. One study found that overperformance had only occurred since 2013 when interest in ESG investing started to rise. In this instance, improved returns might be artificially inflated by the momentum behind ESG investing.<sup>xiii</sup>

Another study looked at companies with high ESG scores to understand where outperformance might be linked to other sector or factor biases. The study found that, whilst European ESG outperformance was not linked to other factors, in the United States (US) it was likely to be associated with other factors such as sector allocation (mainly tech) or high profit to asset ratios.<sup>xiv</sup>

### Do they lead to more responsible business?

The causal link between high ESG scores and improved financial may be inconclusive, but does ESG at least lead to businesses having a positive impact beyond profit? Again, the data paints a mixed picture. One study which compared the records of US companies found that the companies in the ESG portfolios actually had worse compliance records on both labour and environmental rules than non-ESG funds.<sup>xv</sup>

Other research that looked at the relationship between ESG scores found that each individual score had a moderating effect on the other two. This means that a company's focus on one of the parameters (either E, S or G), can independently act as a catalyst to improving the other two parameters and the ESG score as a whole.<sup>xvi</sup>

## HOW CAN RESPONSIBLE BUSINESSES NAVIGATE ESG?

### Are ESG scores consistent?

Another problem with ESG is the inconsistency of scores, which is due to the number of ratings agencies and methodologies used to calculate them, as well as the reliability of data.

For example, NatWest Group, who published their ESG ratings in their 2020 ESG report, scored an AA rating from MSCI, and a C rating from ISS ESG.<sup>xvii</sup> Their ISS ESG rating however, places them in the top 10% of companies in their industry, highlighting the differences in how ratings are applied. There is also very little evidence on why data providers disagree so much – making it difficult to understand the potential consequences and remedies.

Part of the issue may be that ESG is metrics-led, and there is only so much that data can tell us. Unless taken into consideration with 1:1 engagement with a company, ESG ratings tend to be based on public information – this means nuances in the data might get lost e.g., initiatives that are in development and have not been announced yet.

Understanding of how a company's purpose is embedded and what company culture is like is also difficult to ascertain unless the analyst knows the company well. Human biases may affect how data is interpreted, as analysts are likely to score companies differently based on prior knowledge of that company.<sup>xviii</sup>

Another common criticism of ESG scores is that they are outcome rather than impact-led, and that increased transparency does not necessarily mean increased impact. So, whilst ESG ratings place an emphasis on the existence of a company policy or process, they may not show the quality or efficacy of its usage and how its existence contributes to the company's purpose and benefits wider society.

### WHAT DO BITC RECOMMEND?

BITC recommends that businesses getting started on ESG should not get too caught up in individual scores and how they rank. ESG scores are a useful tool to communicate with investors and other stakeholders but should be used to progress your responsible business journey as opposed to an end in themselves. More information on how BITC can support your ESG journey can be found at the end of this briefing.

As responsible business has matured, so has the language used to describe it. Throughout 40 years of BITC, we've seen the concept evolve from businesses with ad hoc philanthropic programmes to businesses that have a clear [purpose beyond profit](#) that is embedded within the strategy and culture of an organisation, based on solid foundations of materiality.<sup>xix</sup>

For most responsible business practitioners, the topics covered by ESG are not new and in many ways, just another way to describe Responsible Business. If you take BITC's Responsible Business Map for example, its issue areas naturally align to ESG.



Figure 1 – BITC's Responsible Business Map

## HOW CAN RESPONSIBLE BUSINESSES NAVIGATE ESG?

**ESG metrics will be a key enabler, but they should not be the end goal. Better outcomes and positive impact must be the drivers of responsible business action.**

### HOW CAN BITC SUPPORT?

At BITC, our purpose is to inspire and engage businesses to tackle some of society's biggest issues, to achieve our vision of making the UK the world leader at Responsible Business. Our interventions and advice are impact-led, designed to create the most positive change for society and the environment.

BITC's [Responsible Business Tracker®](#) is designed with scoring shifted towards the importance of impact and improvement and can be used as a tool to analyse your company's Responsible Business Strategy set against the Global Goals. Our Advisory Services can also support you in designing a Responsible Business Strategy and working on improving any areas highlighted by your scores in the Tracker, ultimately supporting you to not only increase your ESG ratings, but to increase your positive impact.

To find out how you can use [BITC's Responsible Business Map](#) and [Responsible Business Tracker®](#) as an improvement tool and how [BITC Advisory Services](#) can help you on your Responsible Business Journey, get in touch with your BITC Relationship Manager or contact [advisory@bitc.org.uk](mailto:advisory@bitc.org.uk).

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- [learn more about our work on Purpose and Values](#)
- [join us for one of our upcoming events](#)



Talk to one of our expert team today to learn how membership of BITC can help you take your responsible business journey further and drive lasting global change.

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