Centre for Sustainability Reporting and Performance Management

UNIVERSITY OF WATERLOO
SCHOOL OF ACCOUNTING AND FINANCE

Are ESG Ratings a True Measure of Sustainable Practices?

ESG ratings are external assessments that consider the firm's impact on sustainability or its exposure to sustainability-related risk. Specialized ESG rating agencies or data providers, such as MSCI, Sustainalytics, Refinitiv, and Bloomberg, provide ESG ratings to stakeholders. Stakeholders then rely on ESG ratings for various decisions. Recent research has cast doubt on the accuracy and consistency of ESG ratings. One significant concern is the divergence in ESG ratings by different providers. If ESG ratings from different providers measure sustainable practices by firms, they should be highly correlated. However, this is not the case, as research documents a low level of correlation between ESG ratings from different providers. Consequently, the next logical question is: what drives ESG ratings? This research letter surveys three recent studies that address drivers of ESG ratings. These studies shed light on factors influencing ESG ratings that may not align with sustainable practices.

Do Socially Responsible Firms Walk the Talk? The paper examines the actual ESG performance of firms that commit to consider stakeholders beyond shareholders. Firms that commit to improving ESG performance perform worse on various ESG metrics than those that do not. Despite this, they have higher ESG ratings, which appear to be influenced by the voluntary disclosure of information rather than actual ESG performance.

Do Commercial Ties Influence ESG Ratings? The paper examines the conflicts of interest that arise when a credit rating agency acquires an ESG rating agency. The results support the notion that credit rating agencies exert pressure on ESG rating agencies to increase the ESG ratings of the credit rating agencies' clients. Conflicts of interest due to commercial ties can contribute to the divergence of ESG ratings.

***ESG Ratings of ESG Index Providers*.** The paper examines how index licensing incentives affect ESG ratings. Another source of conflict of interest for ESG rating

agencies is the index licensing incentives. The results suggest that ESG rating agencies with high index licensing incentives are biased in assessing ESG ratings. Conflicts of interest due to index licensing incentives can contribute to the divergence of ESG ratings.

Stakeholders look for sources of information other than the firms to assess ESG performance. As a result, ESG ratings have risen in popularity in recent years. However, practitioners need to be aware of the limitations of ESG ratings. The research papers featured in this research letter highlight the presence of biases that distort ESG ratings. The results underscore the need for regulatory oversight within the ESG rating industry.

Amar Mahmoud, School of Accounting & Finance, University of Waterloo

Do Socially Responsible Firms Walk the Talk?

Authors: Aneesh Raghunandan and **Shiva Rajgopal.**

SSRN paper 3609056 Available at SSRN: https://ssrn.com/abstract=3609056

What is the angle of the analysis?

The paper analyzes the commitment made by BRT signatories.

Since 1997, the Business Roundtable (BRT) Statement on the Purpose of a Corporation stated that "corporations exist principally to serve shareholders." A significant shift took place in 2019 when the BRT statement asserted, "we share a fundamental commitment to all of our stakeholders...each of our stakeholders is essential...we commit to deliver value to all of them, for the future success of our companies, our communities, and our country." Many firms signed the new BRT Statement on the Purpose of a Corporation. This paper questions whether the commitments made by corporations who signed BRT's new Statement on the Purpose of a Corporation in 2019 about considering stakeholders' interests beyond shareholders are genuine.

Instead of solely relying on ESG ratings, the paper utilizes several ESG outcome variables.

The paper assesses whether BRT signatory corporations live up to their commitment. It compares how BRT signatory corporations differ from non-signatory corporations on various ESG outcomes, such as labor violations, environmental violations, labor lawsuits, financial misconduct, emissions, lobbying, subsidies, abnormal CEO pay, entrenchment index, the percentage of independent directors, management disagreement on governance proposals, and ESG ratings.

Data and methodology

Sample size.

The sample comprises 135 BRT signatories and 105 control firms, spanning 1,350 weighted firm-years from 2014 to 2018.

Data sources.

The paper relies on several data sources. First, financial statements and market data are from Compustat and CRSP. Second, the paper identifies BRT signatory corporations from a publicly available list on the BRT website. Third, compliance violation data is from the Violation Tracker database compiled by Good Jobs First. Fourth, carbon emissions data comes from Trucost. Finally, the paper relies on various sources for corporate governance characteristics.

Propensity score matching addresses the omitted variable problem.

The paper uses propensity scores to match BRT signatories to similar non-signatory firms based on firm fundamentals. BRT signatories are compared with the matched sample to assess how they differ in ESG outcomes.

BRT signatories perform worse than non-signatories on actual ESG outcomes but better on ESG ratings.

Results

Surprisingly, the paper finds BRT signatories have poor ESG performance compared to non-signatory firms. BRT signatories had higher rates of environmental violations and labor violations. As a result, they pay more penalties. These firms have higher carbon emissions, which is inconsistent with their commitment. They spend more on lobbying and receive more government subsidies. BRT signatories are more likely to recommend voting against resolutions proposed by shareholders in proxy statements. They do not report superior stock performance, which suggests the market interprets their commitment as cheap talk.

The paper endorses the view that the commitments made by BRT signatories are cheap talk.

ESG ratings do not reflect actual ESG performance.

Final take

The paper highlights the need for ongoing scrutiny and evaluation of corporate commitments to stakeholders. Interestingly, the paper shows that ESG ratings do not reflect ESG performance. Even though BRT signatory firms have a worse track record on actual ESG performance than non-signatory firms, they still have higher ESG ratings. Higher ESG ratings seem to be driven by the voluntary disclosure of information rather than actual ESG performance. Therefore, the practitioner needs to be mindful of the limitations of ESG ratings.

Do Commercial Ties Influence ESG Ratings?

Authors: Xuanbo Li, Yun Lou, and **Liandong Zhang**

SSRN paper 4190204 Available at SSRN: https://ssrn.com/abstract=4190204

What is the angle of the analysis?

Conflicts of interest arise when a credit rating agency acquires an ESG rating agency.

Credit rating agencies like Moody's and S&P are expanding into the ESG rating industry. The paper explores the conflicts of interest that arise when a credit rating agency acquires an ESG rating agency. After an acquisition, customers of the credit rating agency become indirect clients of the ESG rating agency. The argument proposed by the paper is that credit rating agencies may exert pressure on the acquired ESG rating agencies to provide the customers of the credit rating agency with higher ESG ratings.

Two recent examples are the Vigeo Eiris and RobecoSAM acquisitions by Moody's and S&P.

The paper assesses the conflicts of interest that arise when a credit rating agency acquires an ESG rating agency using the acquisitions of Vigeo Eiris and RobecoSAM by Moody's and S&P. Credit rating agencies operate using an issuer-pay model. In contrast, ESG rating agencies operate using an investor-pay model. Therefore, the incentives of credit rating agencies to retain customers may lead to material distortions in the ESG ratings issued to these customers.

Data and methodology

Sample size.

The sample comprises 10,961 and 16,909 observations for Moody's and S&P, respectively. There are 4,124 and 4,066 unique firms for Moody's and S&P, respectively.

Data sources.

The paper obtains ESG ratings from Moody's VE Data Lab and S&P's website. It identifies Moody's and S&P customers from Moody's Default & Recovery Database and Capital IQ S&P Credit Ratings.

Difference-in-differences research design.

The paper uses a difference-in-differences research design to assess the effect of credit rating ties on ESG ratings. It compares the difference in ESG ratings for Moody's and S&P clients before and after the acquisition of Vigeo Eiris and RobecoSAM compared to firms that are not clients of Moody's and S&P.

Results

Conflicts of interest due to commercial ties affect ESG ratings.

The paper finds evidence consistent with the conflict of interest affecting ESG ratings. ESG rating agencies issue higher ESG ratings for Moody's and S&P clients than firms that are not clients. The effect of conflicts of interest on ESG ratings is stronger for firms with more intensive business

relationships with Moody's and S&P, firms issuing green bonds, firms disclosing less ESG information, and firms having lower pension ownership.

The higher ESG ratings given to clients helps credit rating agencies retain customers but negatively affects ESG ratings' quality.

The favorable ESG ratings help Moody's and S&P maintain credit rating business. After the acquisition of the ESG rating agencies, the bonds issued by firms with higher ESG ratings from Vigeo Eiris and RobecoSAM are more likely to choose credit ratings from Moody's and S&P. Nevertheless, the conflicts of interest drive down the quality of ESG ratings. After the acquisition, the ESG ratings from Vigeo Eiris and RobecoSAM became less informative of future ESG news. Also, higher ESG ratings are associated with lower future stock returns, suggesting that investors cannot fully see through the bias.

Final take

Be careful when relying on ESG ratings.

Conflicts of interest in the ESG rating industry are a concern. A higher ESG rating does not necessarily imply improved ESG performance. Instead, it might reflect conflicts of interest from commercial ties. The paper highlights the need for vigilance by investors and other stakeholders when relying on ESG ratings. It also points to the need for regulation in the ESG rating industry.

ESG Ratings of ESG Index Providers

Authors: Sonakshi Agrawal, Lisa Yao Liu, Shiva Rajgopal, Suhas A. Sridharan, Yifan Yan, and **Teri Lombardi Yohn.**

SSRN paper 4468531 Available at SSRN: https://ssrn.com/abstract=4468531

What is the angle of the analysis?

Conflicts of interest arise because of index licensing incentives.

The paper examines the relationship between index licensing incentives and ESG ratings. Index licensing represents a significant source of revenue for ESG rating agencies with high index licensing incentives. Asset managers pay index providers a percentage of the fund's assets under management. Previous papers suggest a strong relationship between past equity returns and future fund flows. Consequently, ESG rating agencies with high index licensing incentives may assign well-performing stocks higher ESG ratings to improve the marketability of their indices and attract more future fund flows.

Two examples of ESG rating agencies with high and low index licensing incentives are MSCI and Refinitiv.

The paper uses MSCI and Refinitiv as examples of two rating agencies with high and low index licensing incentives. MSCI derives more than 60% of its operating revenue from index licensing, whereas Refinitiv derives most of its revenue from selling data. The incentives for ESG rating agencies with high index licensing incentives may lead to material distortions in the ESG ratings issued to well-performing stocks.

Data and methodology

Sample size.

The sample comprises 7,214 firm-year observations for 1,691 unique US firms from 2012 to 2019.

Data sources.

The paper relies on several data sources. First, ESG ratings are from MSCI and Refinitiv. Second, financial performance and stock returns are from COMPUSTAT and CRSP. Third, data on institutional ownership and analyst following are from Thomson Reuters Institutional Holding and I/B/E/S. Finally, the quantity of ESG disclosures is from Bloomberg.

The theory proposed by the paper suggests that ESG raters with high index licensing incentives increase the ESG rating of well-performing

The paper performs three main analyses to show how stock performance affects ESG ratings, which then influences index composition. The first analysis assesses the relationship between stock performance and the difference in ESG ratings provided by ESG rating agencies with high and low index licensing incentives. The second analysis shows the link between ESG ratings and index composition. The final analysis is an event study that examines the differences in ESG ratings of ESG rating agencies with high and low index licensing incentives for index additions and deletions.

stocks to include them in ESG indices.

Results

The results support the view that ESG licensing incentives affect ESG ratings.

The findings suggest that firms with better stock performance receive higher ESG ratings from ESG rating agencies with high index licensing incentives than ESG rating agencies with low index licensing incentives. The higher ESG ratings from ESG rating agencies with high index licensing incentives increase the probability of inclusion in an index. Relative to ESG rating agencies with low index licensing incentives, ESG rating agencies with high index licensing incentives assign higher ESG ratings to firms added to their ESG indices. They also assign lower ESG ratings to firms deleted from their ESG indices. The results support the notion that index licensing incentives affect ESG ratings.

Final take

Be careful when relying on ESG ratings.

The paper documents another source of bias that can affect ESG ratings. A higher ESG rating does not necessarily imply improved ESG performance. Instead, it might reflect conflicts of interest from index licensing incentives. The results highlight the need for stakeholder awareness when relying on ESG ratings. They also point to the need for regulatory oversight in the ESG rating industry.