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Sustainable Architecture for Finance in Europe

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Can you trust ESG ratings? A deep dive into trust, transparency, and regulatory challenges

We delve into the EU's regulatory changes aimed at boosting transparency in sustainable investments. By examining disparities among ESG rating agencies, we assess how these differences challenge standardization and consensus. Our analysis underscores the critical need for clearer ESG assessments to guide the sustainable investment landscape

While exploring the crucial role of ESG (Environmental, Social, and Governance) ratings within the investment landscape, a pressing question emerges: Can we trust ESG ratings? This inquiry is paramount to both regulators, who seek dependable assessments of a company's sustainability profile, and investors, who aim to navigate the complex terrain of ESG ratings to mitigate the risks of misallocation and greenwashing.

This discussion unfolds in the context of the European Union's introduction of a new proposal on ESG ratings in February 2024. This legislative initiative underscores the urgent need for clarity and dependability in ESG ratings, a domain where ambiguity has prevailed for too long. Under this new regulation, ESG rating providers operating within the EU must obtain authorization and be under the supervision of the European Securities and Markets Authority (ESMA). The proposal aims to strengthen this double materiality by encouraging ESG rating agencies to more thoroughly evaluate and report how the companies they rate impact ESG factors. This is a step beyond what is currently done. Furthermore, it stipulates that ESG ratings must be explicitly broken down into environmental, social, and governance pillars. If this is not feasible, the agency must clearly explain how much weight each pillar carries for the overall ESG rating. This initiative represents a significant leap forward in enhancing transparency.

Unpacking the ESG rating methodology maze

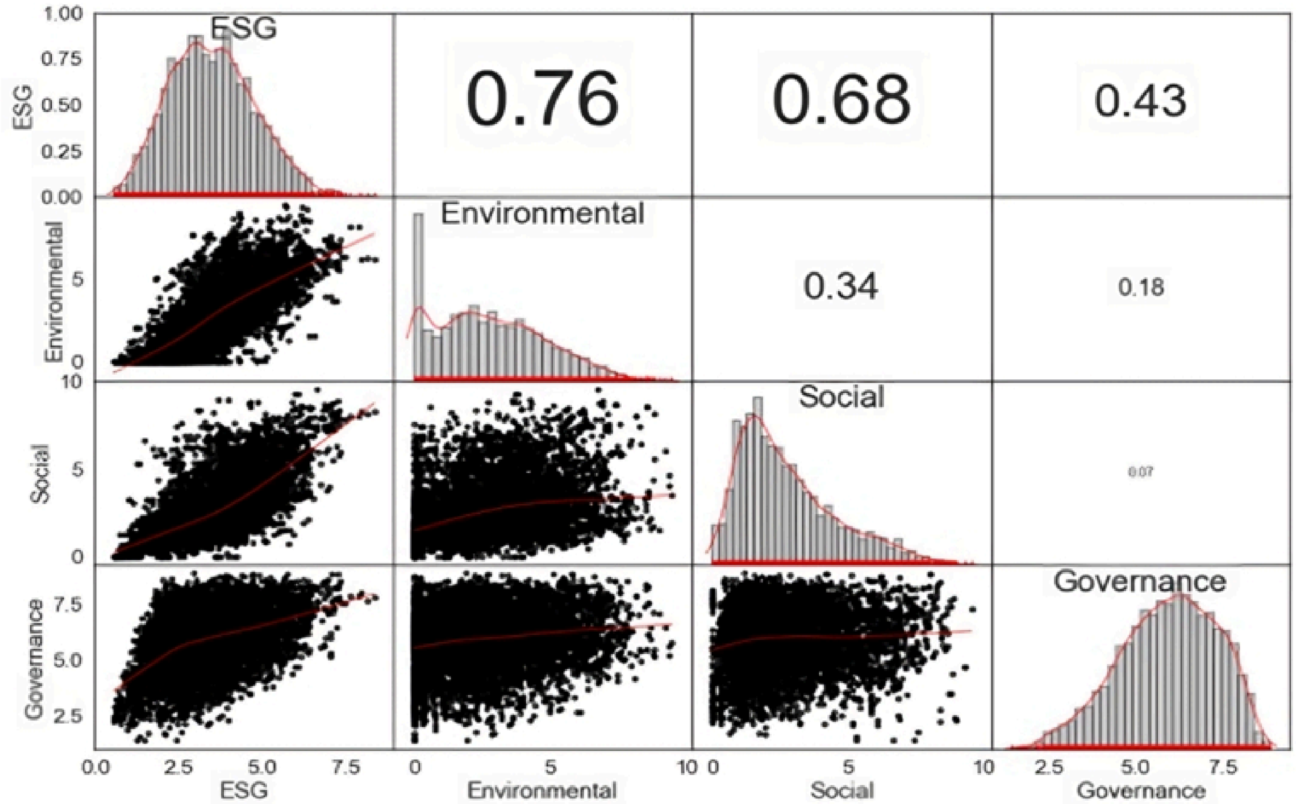
A study conducted by Berg et al. (2022) highlights the necessity of the legislation by uncovering a considerable inconsistency among various providers' ESG ratings, demonstrated by a correlation of just 54%. This disagreement has perverse effects on sustainable investments, leading to the identification of different investment universes and consequently to the creation of different benchmarks (Billio et al. (2021)). In our recently published study , we document the root of this inconsistency in divergent accounting practices. The findings show that the individual pillars of E, S, and G contribute unevenly to the overall ESG score, and reveal low co-movement between the pillars and a significant disagreement among various providers on E, S, and G ratings.

Figure 1 from Billio et al. (2024) shows the correlations and intra-correlations among ESG ratings and their pillars for Bloomberg, Refinitiv, RobecoSAM, and Sustainalytics. This exploration of correlations aims to identify which pillars have the greatest explanatory power on the overall ESG rating. Meanwhile, examining intra-correlations reveals if companies that perform well in one area, such as the environmental dimension, also tend to score highly in social and governance aspects, offering a more nuanced understanding of the interconnectedness of ESG performance.

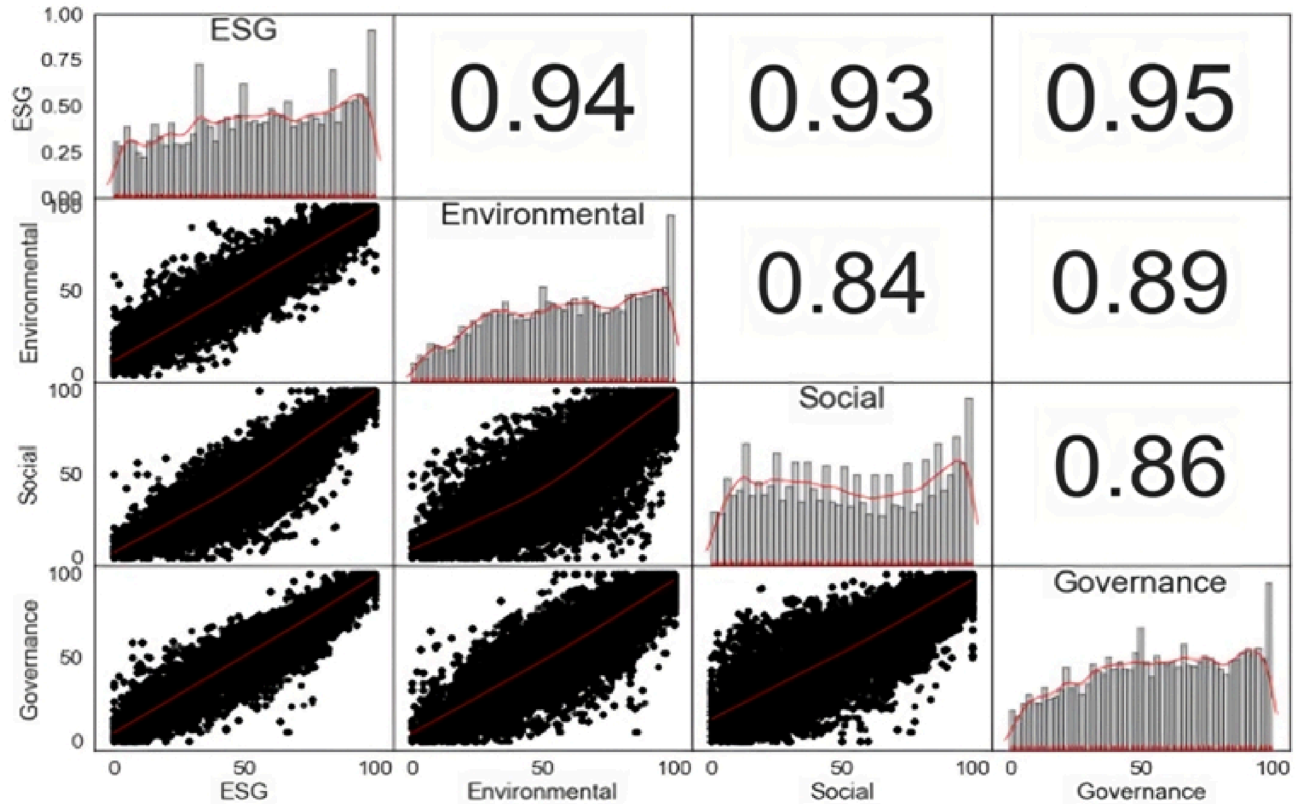
An intriguing pattern emerges, the Environmental pillar exhibits high correlation with the ESG pillar across all the rating agencies, indicating its significant role in explaining the cumulative ESG rating and highlighting the remarkable consistency of its influence across diverse raters. This high degree of correlation diminishes for the Social and Governance pillars, respectively, pointing to their lesser explanatory role in the aggregate ESG score. Thus, it appears that improving environmental practices is the most crucial aspect for firms aiming to enhance their overall ESG ratings. A first lesson emerges: If a company is good in E, it will likely be good in ESG.

However, delving deeper into the intra-correlations of how the pillars co-move, it becomes evident that the Governance pillar frequently diverges from the Environmental and Social pillars. This observation indicates that strength in one area may not necessarily offset shortcomings in another, highlighting the distinct and independent nature of each pillar's contribution to the overall ESG performance.

A second lesson is: Companies have diminished incentives to increase the G pillar. Particularly striking is the intra-correlation of RobecoSAM, which relies on survey data collected from the firm. It showcases exceptionally high correlations/intra-correlation among all three pillars, hinting at an almost binary approach to rating firms: if a firm is good in E, it is good also in S and G. In contrast, the methodologies of Sustainalytics, Bloomberg, and Refinitiv, which predominantly leverage public data sources like company reports and news, diverge markedly from RobecoSAM's. This dichotomy points to underlying challenges in achieving consensus on ESG methodology and assessment.



(a) Bloomberg



(c) S&P (ex RobecoSAM)

Figure 1 - Intra-correlation between Environmental, Social, Governance, and ESG scores for European companies as provided by different rating agencies.

Understanding Variability: A Closer Look at ESG Rating Differences

To better understand the differences among rating agencies, we further dive into the average standard deviation between ESG ratings (and their individual pillars) for a group of companies rated by all four agencies from 2016 to 2021 reported in Figure 2. Using standard deviation in this context helps us understand the level of disagreeance amongst rating agencies. Notably, the Governance dimension, exhibits the greatest deviation, indicating high levels of disagreement; this underscores the difficulty in achieving a unified stance on corporate governance practices amongst raters.

Instead, the overall ESG rating demonstrates the lowest variance, suggesting a higher level of agreement among agencies who don't appear to agree on the individuals' pillars. This indicates that disagreement on the E, S, and G components partially cancel out at the aggregate ESG level, pointing to the noise component that characterizes the ESG rating methodologies.

This juxtaposition underscores the complexity of ESG evaluation, revealing both stark differences and unexpected consensus within the ESG rating industry. This striking contrast underscores the importance of the EU proposal, as it shows that investors relying solely on the overall ESG ratings may not be fully aware of the extent of disagreement among the different pillars, emphasizing the need for greater transparency and detail in ESG reporting.

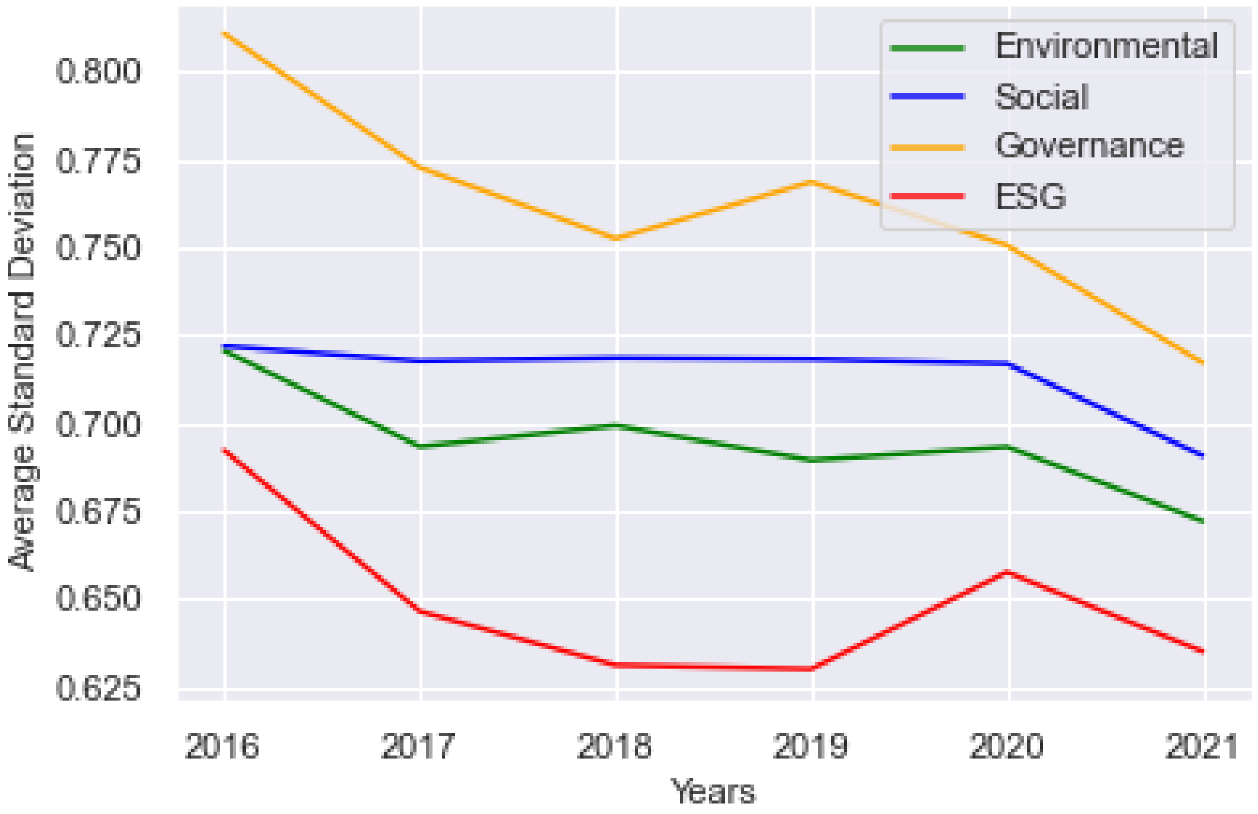


Figure 2 - E, S, G, and ESG rating disagreement over time. The average standard deviation is calculated on a sample of 381 European companies using the rating provided by the four rating agencies.

This research lays bare the complexities and challenges inherent in ESG ratings, while also highlighting the critical importance of transparency and standardization in this field. The EU's regulatory proposal aims to address these challenges by mandating the authorization and supervision of ESG rating providers by the ESMA and enforcing compliance with transparency requirements.

It is incumbent that regulators ensure ESG ratings serve as a reliable compass guiding sustainable investment decisions. This move not only aims to enhance investor and regulatory confidence in ESG ratings but also underscores the importance of individual pillar ratings to prevent diluting the focus on sustainable investment.

In sum, the evolving narrative around ESG ratings, bolstered by academic research and regulatory action, calls for greater clarity and accountability in sustainable finance. As the EU forges ahead with its regulatory framework, the collective efforts of regulators, investors, and rating agencies will be crucial in ensuring that ESG ratings truly reflect the sustainability credentials of companies, guiding investment towards a greener, more sustainable future.

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Monica Billio is Professor of Econometrics at the Ca' Foscari University of Venice and SAFE Fellow.

Aoife Claire Fitzpatrick is a PhD candidate at Goethe University and the Leibniz Institute for Financial Research SAFE.

Carmelo Latino is a PhD candidate at the Leibniz Institute for Financial Research SAFE.

Loriana Pelizzon is director of the department Financial Markets at SAFE and Professor of Law and Finance at Goethe University Frankfurt.

CONTACT

Leibniz Institute for Financial Research SAFE

Theodor-W.-Adorno-Platz 3
60323 Frankfurt am Main

Phone: +49 69 798 30080
Fax: +49 69 798 30077
Email: info@safe-frankfurt.de

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