Why is Corporate Virtue in the Eye of the Beholder? The Case of ESG Ratings, by D.Christensen, G.Serafeim, A.Sikochi

Dicsussion by

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Context 1: Purpose of ESG Ratings

- The purpose of ESG ratings is less specific than that of other ratings
  - For example, credit ratings evaluate the ability of a company to pay back the debt; G-index and E-index account for number of takeover defenses used by a company
  - "ESG Ratings support alignment with the UN Sustainable Development goals" (FTSE Russell); "ESG Ratings aim to measure a company's resilience to long-term, financially relevant ESG risks" (MSCI); "ESG Risk Ratings are designed to help investors identify and understand financially material ESG risks" (Sustainanalytics)
  - ”"The goal on ESG ratings is to look at the sustainability of the business model of the issuer." (Moody's) However, what that means varies from agency to agency. (Financial Times, Sep 17, 2019)

Context 1: Purpose of ESG Ratings

- While there is general agreement that good corporate governance (G part) is important for the preservation and growth of shareholder wealth, the effect of environmental and social factors (ES part) is unclear
- Certain ES policies can have conflicting effects on SDG components

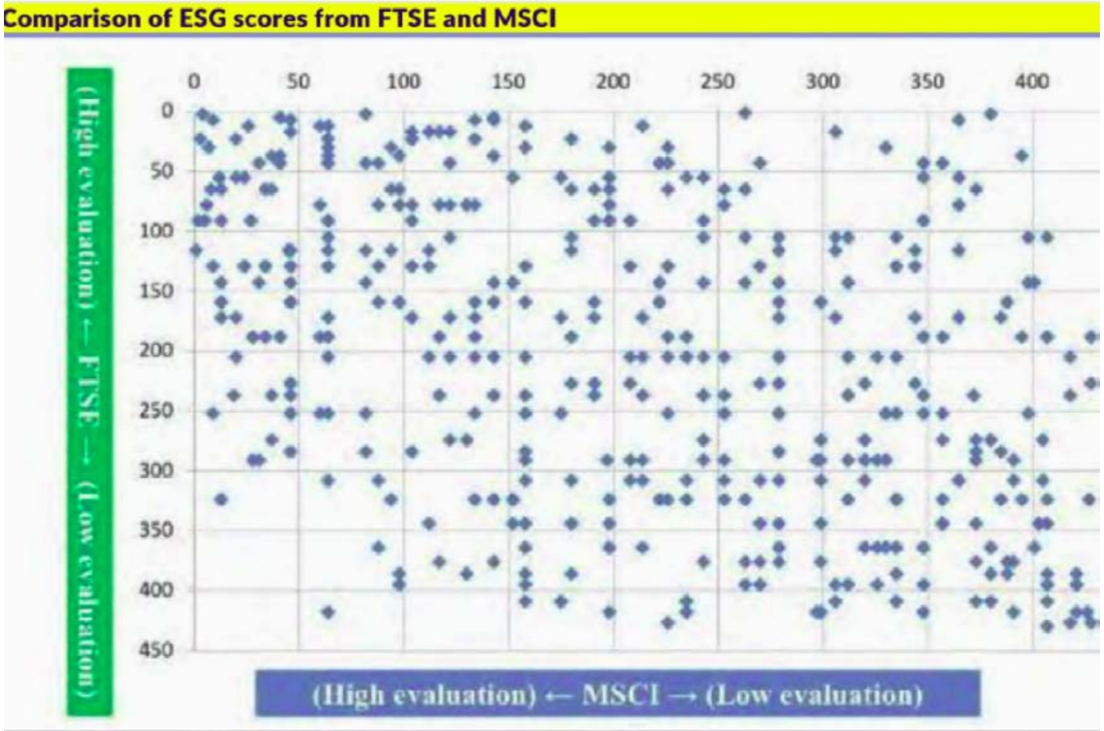
Context 1: Purpose of ESG Ratings

- Assessing the "green risk" (e.g., the effect of climate change on insurance companies) is very different from evaluating companies' alignment with SDGs

- Currently, ESG Ratings shoot in too many directions

- Hence, I tend to disagree that ESG raters are similar to credit rating agencies that "act as information intermediaries and gatekeepers in financial markets" (CSS, page 2). They are more like sell-side research analysts that may disagree in their opinion about ESG performance.

Context 2: ESG Rating Disagreement



Source: CLSA (as reported in Allen (FT, Dec 2018))

*"..as of 17 September FTSE rated Tesla **last** for global auto ESG. MSCI, meanwhile, rated it **best**. In Sustainalytics' rankings, it fell around the **middle** of the pack."*

" …underscores the danger of relying on a simple final score for investment decisions"

Source: "**Lies, damned lies and ESG rating methodologies**" by Kate Allen, Financial Times, December 6, 2018

Context 3: ESG Investing as a Differentiation Strategy for ETFs

- The Global ETF/ETP industry has reached 6 trillion USD with close to 8,000 products by more than 400 providers. (ETFGI)
- ETF Investing has become a commodity and fund providers increasingly search for new ways to attract investors' interest and to differentiate themselves from other funds. ESG investing is one of such differentiation strategies attracting investors that want to make money while "doing good things".
  - "*ESG assets under management have grown the fastest among smart beta strategies, at a compound annual growth rate of more than 70 per cent over the past five years. (…) Demand for smart beta ESG products is starting to come from pension funds. Pressure from governments to adopt ESG strategies is also helping.*" (Financial Times, Nov 4, 2019)
- This trend creates demand for ESG rating services. "*The global market for ESG ratings is currently worth about $200m and (…) could grow to $500m within five years.*" (Financial Times, Sep 17, 2019)

Main Findings of CSS (2019)

- **Greater ESG disclosure leads to greater disagreement across ESG rating agencies**
- The relationship between ESG scores and ESG rating disagreement is non-linear: the rating disagreement is greater when firms have high or low average ESG scores

Comment 1: Is Disagreement Good or Bad?

- **No opinion**: "(…) without taking a stance on whether the disagreement is undesirable or not" (page 2)

vs.

- **Bad**: "(…) as precondition for transparency to *decrease* disagreement (…) the challenge that firms currently face in using disclosure to *mitigate* ESG disagreement" (page 7)

- Suggestion: differentiate between ESG Risk ratings and ESG Sustainability ratings. *Risk* ratings are more similar to credit ratings for which the disagreement should be reduced. Sustainability ratings, however, are more like analyst recommendations and may serve a different purpose.

Comment 2: Is it Disclosure that Leads to Disagreement?

- ESG rating providers use different templates to evaluate companies with respect to how sustainable their business models are
- Perhaps firms with better disclosure are "treated" with more advanced templates that differ considerably between rating agencies

- Alternative hypothesis: Different rating templates lead to higher disagreement for firms with better disclosure

Comment 3: Relationship between Score, Disclosure and Disagreement

ESG Rating Disagreement

Corr=**0.12**; linear

Corr=**-0.05**; non-linear, U

ESG Disclosure

ESG Score

Corr=**0.70**; linear?

- It is a bit unclear what the implied relationship between these three ESG components is
  - In real-life, the relationship is sequential:
    - Good/ Bad ESG firm → decides what to disclose → rating agency assigns a score → ESG rating disagreement is observed
  - In the paper, Disclosure and Score simultaneously affect Disagreement which is somewhat confusing

Comment 4: ESG Ratings over Time

- "(…) the level of ESG disagreement for a given firm has in fact increased over [the last two decades]" (page 4)
- ESG Rating templates have become more elaborate over time leading to higher ESG scoring disagreement between rating agencies

- Real-life scoring example of the Baltic Market Awards
  - When almost all firms get the maximum score, new requirements are added to the scoring template

Comment 5: Policy Implications

- What do your results imply for:
  - Context 1: The purpose of ESG scoring
    - Regulate ESG raters?
    - Forbid "multi-purpose" ESG scores?
  - Context 2: ESG rating disagreement
    - Should it be mitigated?
    - More transparency?
  - Context 3: ESG as a differentiation strategy for ETFs
    - Require ETFs to disclose purpose and methodology of ESG scores used in smart beta strategies?

Smaller Comments

- Page 30: "We also note that it is not possible for us to separate the *two mechanisms* that we hypothesize contribute to the relation between disclosure and disagreement." – It is unclear to what two mechanisms you refer to.
- Diff-in-Diff regression in Table 9 could be better explained.

Summary

- Excellent and very informative paper
- Very well executed
- I would like to see more discussion on alternative hypothesis (different templates lead to disagreement) and more explicit policy implications

Thank you!