

# Why is Corporate Virtue in the Eye of the Beholder: The Case of ESG Ratings

Dane Christensen (University of Oregon)  
George Serafeim (Harvard Business School)  
Siko Sikochi (Harvard Business School)

**New Research on Executive Compensation and on Sustainability**  
**ECGI and Bar Ilan University**  
**December 16-17, 2019**

# The use of ESG information is increasing

**More than \$60 trillion invested using ESG information across various strategies (PRI, 2018)**

**External fund managers required to incorporate responsible ESG practices in their investment process ([www.pic.gov.za](http://www.pic.gov.za))**

# The use of ESG information is increasing

**More than \$60 trillion invested using ESG information across various strategies (PRI, 2018)**

**Adjustments to interest rate and fees paid depending on ESG performance (WSJ, March 29, 2019)**

**External fund managers required to incorporate responsible ESG practices in their investment process ([www.pic.gov.za](http://www.pic.gov.za))**

# The use of ESG information is increasing

More than \$60 trillion invested using ESG information across various strategies (PRI, 2018)

Adjustments to interest rate and fees paid depending on ESG performance (WSJ, March 29, 2019)

External fund managers required to incorporate responsible ESG practices in their investment process ([www.pic.gov.za](http://www.pic.gov.za))

ESG concerns affected corporate ratings in approximately 10% of corporate ratings (S&P Global Ratings, 2017)

22% of over 22,000 corporate ratings influenced by ESG factors (Fitch Ratings, 2019)

# The use of ESG information is increasing

More than \$60 trillion invested using ESG information across various strategies (PRI, 2018)

Adjustments to interest rate and fees paid depending on ESG performance (WSJ, March 29, 2019)

External fund managers required to incorporate responsible ESG practices in their investment process ([www.pic.gov.za](http://www.pic.gov.za))

ESG concerns affected corporate ratings in approximately 10% of corporate ratings (S&P Global Ratings, 2017)

From 2014 - 2018 spending on ESG ratings increased from \$200 to \$500 million (Gilbert, 2019)

22% of over 22,000 corporate ratings influenced by ESG factors (Fitch Ratings, 2019)

# Yet, there is a lack of agreement across ESG ratings

- When ESG providers rate firms there's often little overlap. Yet, credit rating agencies are much more often in agreement (Sindreu and Kent 2018, WSJ)
- ESG scoring is at risk of creating a false sense of confidence among investors (Allen 2018, FT)

## Yet, there is a lack of agreement across ESG ratings

- When ESG providers rate firms there's often little overlap. Yet, credit rating agencies are much more often in agreement (Sindreu and Kent 2018, WSJ)
- ESG scoring is at risk of creating a false sense of confidence among investors (Allen 2018, FT)

**What is the extent to which a firm's ESG disclosure and average ESG performance affect ESG rating disagreement?**

# What drives the disagreement? Summary of findings

Table 5, Panel A: Mean ESG Disagreement

		ESG_Avg			Diff
		Low	Medium	High	
ESG Disclosure	Low	12.91	8.93	11.46	-1.45
	Medium	14.27	9.84	12.74	-1.53
	High	17.91	12.09	13.70	-4.21
	Diff	5.00	3.16	2.24	



## What drives the disagreement? Summary of findings

Table 5, Panel A: Mean ESG Disagreement

		ESG_Avg			Diff
		Low	Medium	High	
ESG Disclosure	Low	12.91	8.93	11.46	-1.45
	Medium	14.27	9.84	12.74	-1.53
	High	17.91	12.09	13.70	-4.21
	Diff	5.00	3.16	2.24	

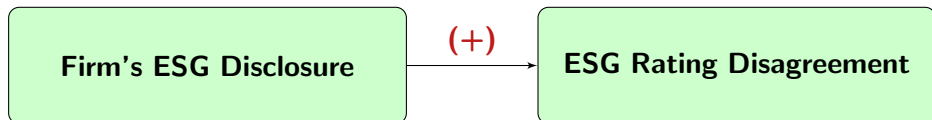
**Contrary to evidence in other settings that disclosure mitigates disagreement in equity and debt markets, in the ESG setting, greater disclosure leads to greater disagreement**

# Hypothesis on ESG disclosure effects

- **As disclosure increases, analysts have to make judgements about ESG performance of the firm**
- **Given the properties of ESG disclosure and evaluative practices, greater disclosure is likely to give rise to disagreement**

## Hypothesis on ESG disclosure effects

- As disclosure increases, analysts have to make judgements about ESG performance of the firm
- Given the properties of ESG disclosure and evaluative practices, greater disclosure is likely to give rise to disagreement



# H1 Anecdotes - Workday Inc.

- ① **FY 2014: No CSR report (but had one in FY 2012)**
  - Its reports come out every 2 years
  - 58 pages
- ② **FY 2015: Issued a CSR report**
  - 94 pages
- ③ **ESG disclosure and rating assessments:**
  - Bloomberg: ↑ E & S disclosure scores
  - Thomson Reuters: ↑ E & S ratings
  - MSCI: ↓ E & ↑ S ratings
  - Sustainalytics: No  $\Delta$  E & ↑ S ratings

# Performance and disagreement in other settings



Hope (2003)

**Analysts forecast dispersion indicate task complexity is higher for worse performing firms**



Cantor and Packer (1994)

**Worse rated firms (i.e., lower average credit rating) have higher uncertainty and thus greater credit rating disagreement**



Iannotta (2006)

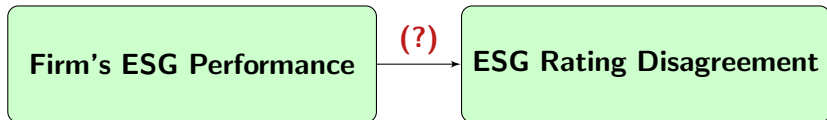
**The relationship between average credit ratings and credit rating disagreement is concave (i.e., it is non-linear)**

## Hypothesis on ESG performance effects

- 1 On one hand, it might be easier for ESG rating agencies to agree when the company is clearly deficient in its ESG practices
- 2 On the other hand, it might be easier to agree on companies that adopt more policies and exhibit better ESG outcomes

## Hypothesis on ESG performance effects

- 1 On one hand, it might be easier for ESG rating agencies to agree when the company is clearly deficient in its ESG practices
- 2 On the other hand, it might be easier to agree on companies that adopt more policies and exhibit better ESG outcomes



## Key variables and data sources

### ESG Rating Disagreement (*ESG\_Disagreement*)

The **standard deviation of a firm's ESG ratings** for year  $t$ 's ESG performance from MSCI, Thomson Reuters (TR), Sustainalytics

The ratings range from 0 to 100

### ESG Disclosure (*ESG\_Disclosure*)

Bloomberg score based on the extent of a firm's ESG disclosure

Ranges from 0.1 for companies that disclose a minimum amount of ESG data to 100 for those that disclose every data point collected by Bloomberg

### ESG Performance (*ESG\_AVG*)

The average ESG rating a firm receive for year  $t$ 's ESG performance



# Effects of ESG disclosure and performance

Dependent variable: ESG Rating Disagreement (Table 6)

	OLS		OLS w/ FFE*		Changes Model				
	Coef.	t-stat.	Coef.	t-stat.	Coef.	t-stat.			
<b>ESG_Disclosure</b>	<b>0.127</b>	<b>16.29</b>	<b>***</b>	<b>0.094</b>	<b>10.23</b>	<b>***</b>	<b>0.053</b>	<b>5.99</b>	<b>***</b>
<b>ESG_Avg</b>	<b>-0.158</b>	<b>-19.32</b>	<b>***</b>	<b>-0.206</b>	<b>-18.09</b>	<b>***</b>	<b>-0.214</b>	<b>-18.22</b>	<b>***</b>
Firm Controls	Yes			Yes			Yes		
ESG Rater F.E.	Yes			Yes			Yes		
Year F.E.	Yes			Yes			Yes		
Industry F.E.	Yes			No			Yes		
Country F.E.	Yes			No			Yes		
Firm F.E.	No			Yes			No		
Adj. R2	0.118			0.516			0.053		
N	30,700			30,700			24,234		

# Effects of ESG disclosure and performance

Dependent variable: ESG Rating Disagreement (Table 6)

	OLS		***	OLS w/ FFE*		***	Changes Model		***
	Coef.	t-stat.		Coef.	t-stat.		Coef.	t-stat.	
<b>ESG_Disclosure</b>	<b>0.127</b>	<b>16.29</b>	<b>***</b>	<b>0.094</b>	<b>10.23</b>	<b>***</b>	<b>0.053</b>	<b>5.99</b>	<b>***</b>
<b>ESG_Avg</b>	<b>-0.158</b>	<b>-19.32</b>	<b>***</b>	<b>-0.206</b>	<b>-18.09</b>	<b>***</b>	<b>-0.214</b>	<b>-18.22</b>	<b>***</b>
Firm Controls	Yes			Yes			Yes		
ESG Rater F.E.	Yes			Yes			Yes		
Year F.E.	Yes			Yes			Yes		
Industry F.E.	Yes			No			Yes		
Country F.E.	Yes			No			Yes		
Firm F.E.	No			Yes			No		
Adj. R2	0.118			0.516			0.053		
N	30,700			30,700			24,234		

**\* One SD increase in ESG disclosure (ESG AVG) → 11.4% (23.2%) increase (decrease) in ESG disagreement**

# Disclosures of individual ESG pillars

Dependent variable: ESG Rating Disagreement (Table 7)

	OLS			OLS w/ FFE			Changes Model		
	Coef.	t-stat.		Coef.	t-stat.		Coef.	t-stat.	
<b>E_Disclosure</b>	<b>0.075</b>	<b>10.16</b>	<b>***</b>	<b>0.047</b>	<b>5.95</b>	<b>***</b>	<b>0.031</b>	<b>4.37</b>	<b>***</b>
<b>S_Disclosure</b>	<b>0.018</b>	<b>2.82</b>	<b>***</b>	<b>0.036</b>	<b>5.20</b>	<b>***</b>	<b>0.012</b>	<b>1.93</b>	<b>*</b>
<b>G_Disclosure</b>	<b>0.039</b>	<b>3.77</b>	<b>***</b>	<b>-0.003</b>	<b>-0.34</b>		<b>0.004</b>	<b>0.45</b>	
<i>ESG_Avg</i>	-0.158	-19.29	***	-0.207	-18.15	***	-0.214	-18.20	***
Firm Controls	Yes			Yes			Yes		
ESG Rater F.E.	Yes			Yes			Yes		
Year F.E.	Yes			Yes			Yes		
Industry F.E.	Yes			No			Yes		
Country F.E.	Yes			No			Yes		
Firm F.E.	No			Yes			No		
Adj. R2	0.119			0.517			0.052		
N	30,700			30,700			24,234		

# Disclosures of individual ESG pillars

Dependent variable: ESG Rating Disagreement (Table 7)

	OLS			OLS w/ FFE			Changes Model		
	Coef.	t-stat.		Coef.	t-stat.		Coef.	t-stat.	
<b>E_Disclosure</b>	<b>0.075</b>	<b>10.16</b>	<b>***</b>	<b>0.047</b>	<b>5.95</b>	<b>***</b>	<b>0.031</b>	<b>4.37</b>	<b>***</b>
<b>S_Disclosure</b>	<b>0.018</b>	<b>2.82</b>	<b>***</b>	<b>0.036</b>	<b>5.20</b>	<b>***</b>	<b>0.012</b>	<b>1.93</b>	<b>*</b>
<b>G_Disclosure</b>	<b>0.039</b>	<b>3.77</b>	<b>***</b>	<b>-0.003</b>	<b>-0.34</b>		<b>0.004</b>	<b>0.45</b>	
<i>ESG_Avg</i>	-0.158	-19.29	***	-0.207	-18.15	***	-0.214	-18.20	***
Firm Controls	Yes			Yes			Yes		
ESG Rater F.E.	Yes			Yes			Yes		
Year F.E.	Yes			Yes			Yes		
Industry F.E.	Yes			No			Yes		
Country F.E.	Yes			No			Yes		
Firm F.E.	No			Yes			No		
Adj. R2	0.119			0.517			0.052		
N	30,700			30,700			24,234		

Consistent results when we regress disagreement for each individual ESG pillar on disclosure of the respective individual ESG pillar

# Mandatory ESG disclosure shocks

Table 9

Dependent Variable:	Validation			Diff-in-Diff		
	<i>ESG_Disclosure</i>			<i>ESG_Disagreement</i>		
	Coef.	t-stat.		Coef.	t-stat.	
<b>Mandatory_Disclosure</b>	<b>1.431</b>	<b>5.26</b>	<b>***</b>	<b>0.432</b>	<b>2.14</b>	<b>**</b>
<b>ESG_Avg</b>	<b>0.273</b>	<b>21.42</b>	<b>***</b>	<b>-0.181</b>	<b>-15.81</b>	<b>***</b>
Firm Controls	Yes			Yes		
ESG Rater F.E.	Yes			Yes		
Year F.E.	Yes			Yes		
Firm F.E.	Yes			Yes		
Adj. R2	0.885			0.511		
N	30,700			30,700		

# Mandatory ESG disclosure shocks

Table 9

Dependent Variable:	Validation			Diff-in-Diff		
	<i>ESG_Disclosure</i>			<i>ESG_Disagreement</i>		
	Coef.	t-stat.		Coef.	t-stat.	
<b>Mandatory_Disclosure</b>	<b>1.431</b>	<b>5.26</b>	<b>***</b>	<b>0.432</b>	<b>2.14</b>	<b>**</b>
<b>ESG_Avg</b>	<b>0.273</b>	<b>21.42</b>	<b>***</b>	<b>-0.181</b>	<b>-15.81</b>	<b>***</b>
Firm Controls	Yes			Yes		
ESG Rater F.E.	Yes			Yes		
Year F.E.	Yes			Yes		
Firm F.E.	Yes			Yes		
Adj. R2	0.885			0.511		
N	30,700			30,700		

Exploits passage of broad mandatory ESG disclosure requirements, going into effect in many countries at different times during sample period (Appendix B)

# Commitment to ESG: Policies or Outcomes?

## Tech giants sued over child deaths in DRC cobalt mining

Apple, Google and Tesla flout their own policies in sourcing material, says human rights group



© Federico Scoppa/AFP/Getty



## Refining hypotheses on ESG Performance

		ESG_Ratings_Metrics		
		Inputs	Outputs	Outcomes
ESG_Disclosure	Inputs	Low	High	High
	Outputs	High	Low	High
	Outcomes	High	High	Low



## Research summary

- We investigate the extent to which ESG disclosure and performance affect ESG rating disagreement among raters
- We find that ESG disclosure increases rating disagreement:
  - 1 ESG disclosure positively associated with ESG rating disagreement
  - 2 Results driven by environmental (E) and social (S) disclosures
- We also find that ESG performance affects ESG rating disagreement:
  - 1 ESG performance negatively associated with ESG rating disagreement
  - 2 The highest disagreement among firms with the lowest ESG ratings followed by firms with the highest ESG ratings

## Concluding remarks

- Overall, our findings shed light on the drivers of ESG rating disagreement
- Understanding why providers disagree helps understand the potential remedies and consequences of this disagreement
- A shared understanding of what constitutes good or bad ESG performance is critical to increasing consistency of ESG ratings

# Thank You!

ssikochi@hbs.edu

<http://hbs.edu/ssikochi>