E S G   I N V E S T I N G

ESG Ratings: A Compass without Direction

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ESG ratings firms provide information to investors, analysts, and corporate managers about the relation between corporations and non-investor stakeholders interests. Recently, ESG ratings providers have come under scrutiny over concerns of the reliability of their assessments. In this Closer Look, we examine these concerns. We review the demand for ESG information, the stated objectives of ESG ratings providers, how ratings are determined, the evidence of what they achieve, and structural aspects of the industry that potentially influence ratings. Our purpose is to help companies, investors, and regulators better understand the use of ESG ratings and to highlight areas where they can improve. We find that while ESG ratings providers may convey important insights into the nonfinancial impact of companies, significant shortcomings exist in their objectives, methodologies, and incentives which detract from the informativeness of their assessments.

We ask:

- Why do ESG ratings often fail to meet their stated objectives? Is it due to methodological choices these firms make, or the sheer challenge of measuring a concept as broad and all-encompassing as “ESG?”

- Are fund managers properly motivated to ensure ESG ratings are reliable in predicting risk and performance? What steps do they take to validate ratings before using them?

- Despite their weaknesses, do ESG ratings have a role to play in reporting and compliance purposes?

- Would more expansive corporate disclosure improve the quality of ESG ratings? Is it even possible for companies to disclosure the vast number of stakeholder-related metrics that feed into ESG ratings?

- Should the SEC establish policies, procedures, and protections to reduce conflicts of interest and improve market confidence in the quality of ESG ratings?