UNCHARTED TERRITORY: NEW REPORT FINDS INFLUENTIAL ESG RATING AGENCIES ARE SUBJECTIVE, INCONSISTENT, AND LACK STANDARDIZATION

ACCF questions the current ratings process used for ESG investment

WASHINGTON, D.C. July 19, 2018 – As the trend of Environmental, Social, and Governance (ESG) investing has risen as an investment priority, so too has the influence and relative importance of ESG rating agencies. With an increasing focus on social corporate responsibility, the ability to portray a positive image around ESG-related topics is critical. However, a new report from the American Council for Capital Formation (ACCF) finds that the major rating agencies have significant disparities in the accuracy, value, and importance of their individual ratings to investors, and arguably undermine the validity of ESG investment strategies.

The report, "*Ratings that Don't Rate: The Subjective World of ESG Ratings Agencies*," provides a comprehensive assessment of the four major ESG ratings agencies, encompassing their history and the role they play in the investment landscape today, as well as the individual ratings criteria they utilize. Findings reveal significant disparities in ratings due to a lack of standardization, inconsistencies, and subjective interpretation influenced by a number of biases – including company size, geography, and industry specific criteria.

"Many of the world's largest investment firms are currently using inconsistent and subjective ESG ratings," said **Tim Doyle, ACCF's Vice President and General Counsel**, and author of the report. "Much as we found in our previous report on proxy advisors, ratings agencies are currently operating with little oversight or standardization, causing their ratings to be based on opinion rather than an assessment of data. This has serious implications when coupled with the lack of transparency and conflicts of interest within proxy advisory firms, as ESG focused investors are deploying capital based on inaccurate information and flawed guidance, and calls into question the entire basis on which they make decisions."

Though modern ESG investing has been practiced for over a decade now, there is still a lack of accurate data to support the evaluation process. To meet growing customer demand and attract ESG-orientated capital, companies have begun making selective and unaudited disclosures in regard to their performance. These disclosures are then utilized by ESG rating agencies, despite the fact that there are neither standardized rules, nor an auditing process to verify company data.

Inconsistencies in the disclosure process inevitably leads to different ratings for the same company based on a lack of uniform rating scales, criteria, and objectives. As a result, assumptions must be used in the calculation which only adds to the subjective nature of these ratings.

ACCF's research shows that there are also inherent biases that affect ratings: size bias, whereby companies with greater market capitalization score higher on ESG ratings than smaller peers; geographic bias, whereby companies in regions with mandatory reporting requirements score meaningfully better than their peers in geographies without mandatory reporting; and industry sector bias, whereby companies in the same industry are unfairly evaluated because a model does not account for serious differences in business models or risk exposure.

Many of the concerns discussed in the report parallel findings within the proxy advisory industry, including a lack of transparency, oversight, and reliance on unaudited disclosures for recommendations on shareholders proposals, several of which are ESG related. ACCF previously published a paper about the conflicted role of proxy advisors, and the influence they have over often politically-motivated shareholder proposals through the analysis, recommendations, and consulting services they provide on how proxies should be voted.

The full text of the ACCF's "*Ratings that Don't Rate: The Subjective World of ESG Ratings Agencies*", is available here. Additional materials and commentary can be found at ACCF.org.

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The American Council for Capital Formation is a nonprofit, nonpartisan economic policy organization dedicated to the advocacy of pro-growth tax, energy, environmental, regulatory, trade and economic policies that encourage saving and investment.