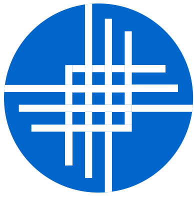


ESG Ratings: The Road Ahead

Research Brief

It's taken a while, but so-called ESG factors—short for environmental, social, and governance issues—have become a priority for investors (see figure below), spurring companies to up their game on social responsibility.

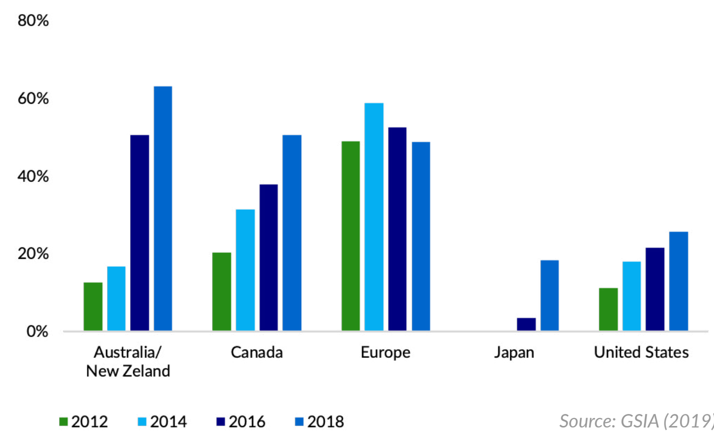
By providing clear, cost-effective, and consistent information about companies' ESG performance, rating agencies can help investors pinpoint firms that meet their ESG philosophies and standards.

While many investors regularly rely on ESG ratings to inform their decisions, they find them difficult to use and are sometimes frustrated by them. Inconsistencies and lack of comparability have proved particularly confusing. And this confusion has become a significant barrier to the adoption of ESG investing.

What Do We Do?

We show that defining a standard set of variables would partially resolve inconsistencies and lack of comparability among rating providers, which often confuse investors. Furthermore, we dissociate the impact of the rating agencies' methodologies (i.e., different focus on E, S, or G factors) from that of using non-standardized data. While the former—if properly disclosed—can be useful as it allows investors to choose ratings that align with their demands and motivations, the latter necessarily requires data harmonization.

Percent of Assets under Management with ESG Mandate, 2012–2018



Source: GSIA (2019)

Policy Implications

Our research offers three insights on improving the ESG rating landscape.

Standard Setting. There is a need for data standardization. Without a structured framework to report and monitor firms' ESG information, the burden lies on companies to communicate their initiatives and on investors to research them. New technologies, such as big data analysis and AI, can help process a larger set of information from different sources, including firms' communication strategies and other alternative resources. However, there is a need to define a core set of variables that would capture companies' efforts as part of a long-term ESG strategy. Rating agencies could then process this information and provide their assessment of the firms.

Better Data Disclosure. Data harmonization would reduce the reporting burden on firms and increase the quality of the information collected. The use of standardized data would also lead to more comparable ratings. This would benefit both the firms being evaluated and the investors using these evaluations; it would lead to a clearer link between the information and its impact on the assessment. A firm could then decide the appropriate strategy to improve its rating (or not), and investors would understand the implications of the rating in terms of ESG risk management.

More Transparency. Rating agencies do not have to agree on a single definition of ESG performance any more than institutional investors have to agree on one. But rating agencies must be transparent regarding the method they use in their ESG assessments. Every user of the rating should be able to understand what ESG issues are being prioritized and to what degree. Are E, S, and G factors equally important? Or does the rating focus mostly on one dimension?

For questions or comments, please email us at *research@milkeninstitute.org*
To view the full report, visit *milkeninstitute.org/report/esg-ratings-road-ahead*