Discussion of “Rewriting History II: The (Un)predictable Past of ESG Ratings”

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This Paper

- Refinitiv retrospectively rewrites its historical ESG data on an ongoing basis, often without announcing these changes to the public
- There seem to be some patterns in its rewriting, based on the authors’ two downloads (September 2018 & September 2020)
    - Majority (87%) of the sample observations were downgraded
    - Rewriting is associated with past stock return (especially for E&S subscores), firm size, sales growth, profitability, R&D, etc., but the direction of effect varies across different subscores
    - Event study: when Refinitiv announced change in its methodology in March 2020, firms that were upgraded exhibit positive CARs, whereas firms that were downgraded exhibit negative CARs
- Retroactive ESG score rewriting by Refinitiv leads to:
    - Large changes in what are deemed to be high- or low-ESG firms
    - Exaggeration on the benefits of being a high-E&S firm during the COVID-19 crisis

Overall Assessment

- Refinitiv ESG and other ESG ratings have a lot of problems
  - Many major asset managers (incl. BlackRock) no longer use Refinitiv and other 3rd-party ESG ratings, but develop their own in-house ratings
  - Not sure whether the authors' critiques are the "right" problems to focus on

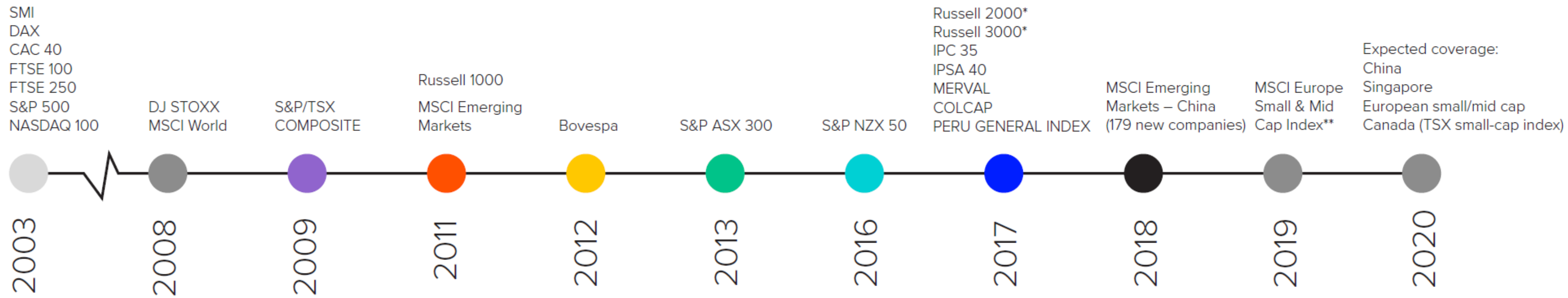
- My comments will be around:
  - How ESG ratings are constructed
  - Whether we should interpret the results as rewriting or recalibrating
  - The incentives for the rater to rewrite ESG scores
  - Contribution and where we are heading

How Are Ratings Constructed

- Different agencies use different rating methods:
  - Best-in-class (Refinitiv, Sustainalytics), letter-grade rating AAA-CCC (MSCI), strength-concerns aggregation (KLD – now MSCI ESG STAT)
  - Convergence of rating methodology, partially due to rating industry consolidation (e.g., KLD acquired by MSCI; Trucost acquired by S&P Global)

- Refinitiv ESG uses a best-in-class approach in its rating
  - That is, scores are relative (percentile ranking) and will be recalculated when new companies are added into the sample (which are on-going)
  - A company's relative ranking, thus its ESG score, can move up or down depending on how it is compared with the newly added company
  - Such addition of companies is usually due to index inclusion
  - That's also why the median score changes are 0% (by construction)

How Are Ratings Constructed



How Are Ratings Constructed

- E&S scores are industry-adjusted; G-scores are country-adjusted
  - That is, it's only sensible to compare Environmental issues between two companies in the same industry, …
  - … and compare Governance quality between two companies in the same country
  - This is consistent with the findings in Table 4 (Panel A) on variance decomposition of the deviation in ESG scores
- As newly added indices disproportionally represent industries and countries, it is unsurprising that changes in ESG subscores do not coincide in direction & magnitude.

Suggestion:

- Reconcile the rewriting pattern with the pattern of new indices/companies being added into the sample (Directly calling them may be a more efficient way);
- Separate adjustment (FE, demeaning, etc.) in industry for E&S scores and adjustment in country for G score in the analysis.

Rewriting or Recalibrating?

- Is retrospective ESG rating adjustment appropriate?
  - Ex-post score changes are systematic, partially driven by reassessments of industry and country level drivers of ESG risks, and related to firm characteristics
  - Shouldn't this be the case?
- It is logical to (re)calibrate ratings over time with new information available
  - Calibrating based on observables can go either direction, consistent with the evidence in Table 5 (i.e., the effects vary across E, S, G subscores)
- The real questions are:
  - Can the current (2020) ratings better predict future (2021 onward) stock returns?
  - Are majority of the ESG scores downgraded continuously? Or are they "mean-reverting"?

Suggestion:

- Have more downloads on higher frequency, and see if the predictive power of ESG scores on stock returns get stronger over time.

Rater’s Incentive to Rewrite

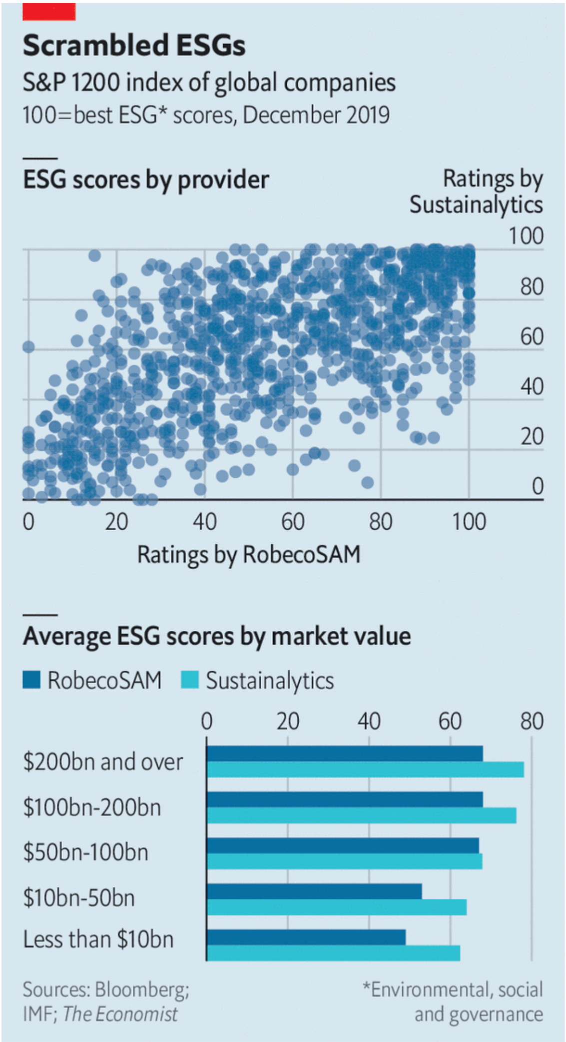
- What’s the incentive for rewriting?
- Different from bond ratings which adopt an issuer-pay model, ESG ratings usually use an investor-pay model
  - Many studies consider investor-pay model being preferred, as it solves the conflict-of-interest problem in the issuer-pay model
- From rating agency’s perspective, they may want to convince investors that their ESG ratings are “useful”
  - This may be the reason that rewritten ESG ratings are hardwired with stock returns

Suggestion:

- A potential angle of the study, rather than saying “I find a problem in the rating,” is to explore the incentives of raters to change their ratings under the investor-pay model;
- Is this another agency problem by rating agencies, i.e., catering to investors’ taste by arbitrarily changing their ratings?

Contribution

- We already know there are many problems with ESG ratings
  - Incomparability between different ESG metrics, size bias, reporting bias, inconsistencies in methodology, low correlation (e.g., 30%) between different ratings, etc.
  - This paper: one major rating agency also changes its historical data without notifying users
  - Is this finding significant enough, in light of many other problems that are well documented and the fact that more and more asset managers are developing their own ratings?
- As researchers, should we triangulate our analysis with different ESG ratings (as recommended by Chatterji, Durand, Levine, Touboul, 2016 SMJ)?
- Do other rating agencies also rewrite their historical data?
- Are the consequences of ESG score rewriting of similar magnitudes as that of lacking standard, size bias, and disagreement between raters?



The Economist

Where Are We Heading?

- It is not difficult to find problems, especially with new data
  - I knew there were problems with all these ESG ratings when I was a PhD student, but I also believe that we should start somewhere to make progress
- As 40+ trillions of dollars are invested in ESG issues globally, it’s more important to understand where we **should** be heading
- Call for more objective, transparent, and scientific frameworks for impact measurement
- Combined with policy frameworks:
  - E.g., UN Sustainable Development Goals (SDGs), EU Taxonomy, Sustainable Finance Disclosure Regulation (SFDR), Non-Financial Reporting Directive (NFRD), Corporate Sustainability Reporting Directive (CSRD), etc.
  - And other reporting/disclosure standard frameworks: SASB, IIRC, GRI, CDP, TCFD, IFRS, CDSB, ISO, PRI, CFA Institute, European SRI Transparency Code, etc.

ESG & Impact Measurement

What are the differences between ESG measurement and impact measurement?

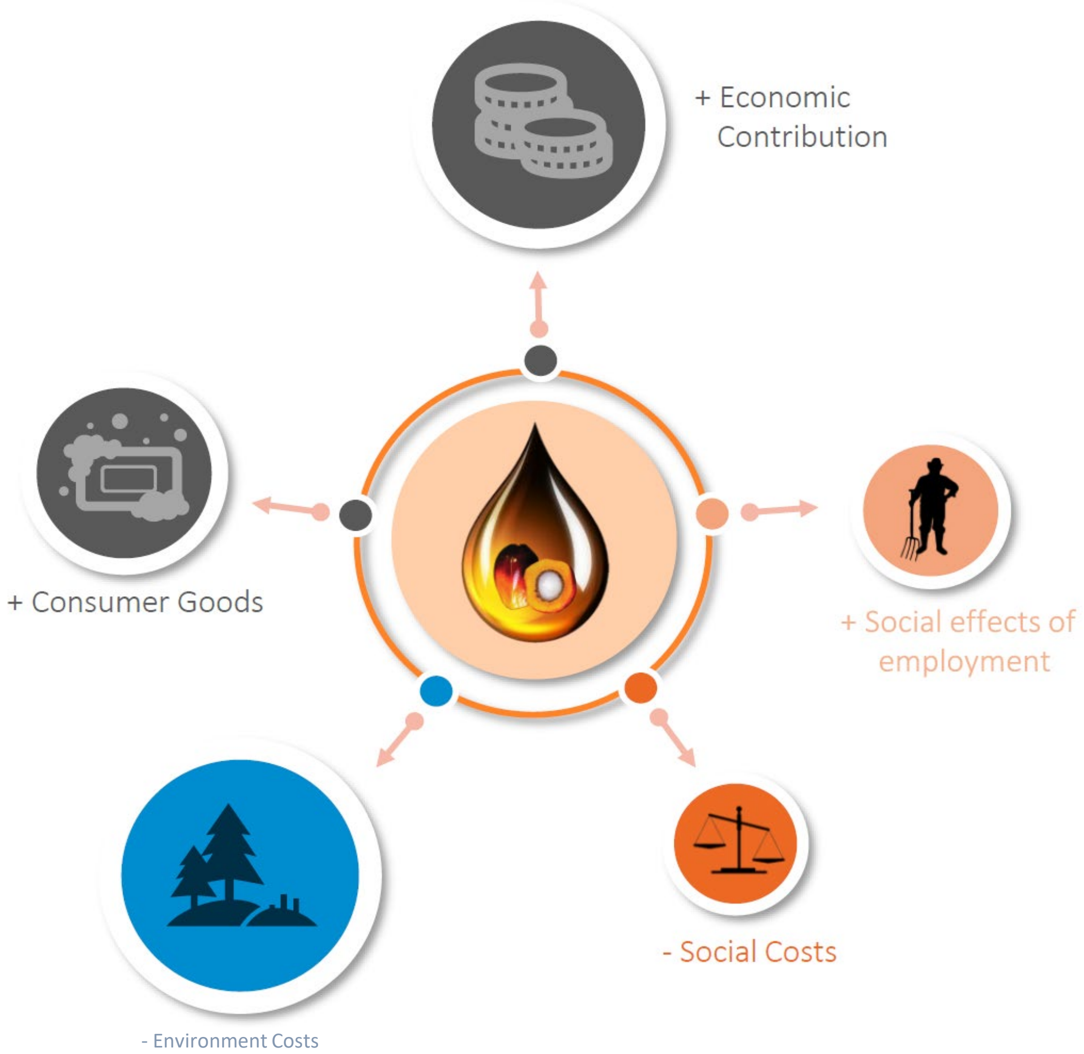
ESG Measurement

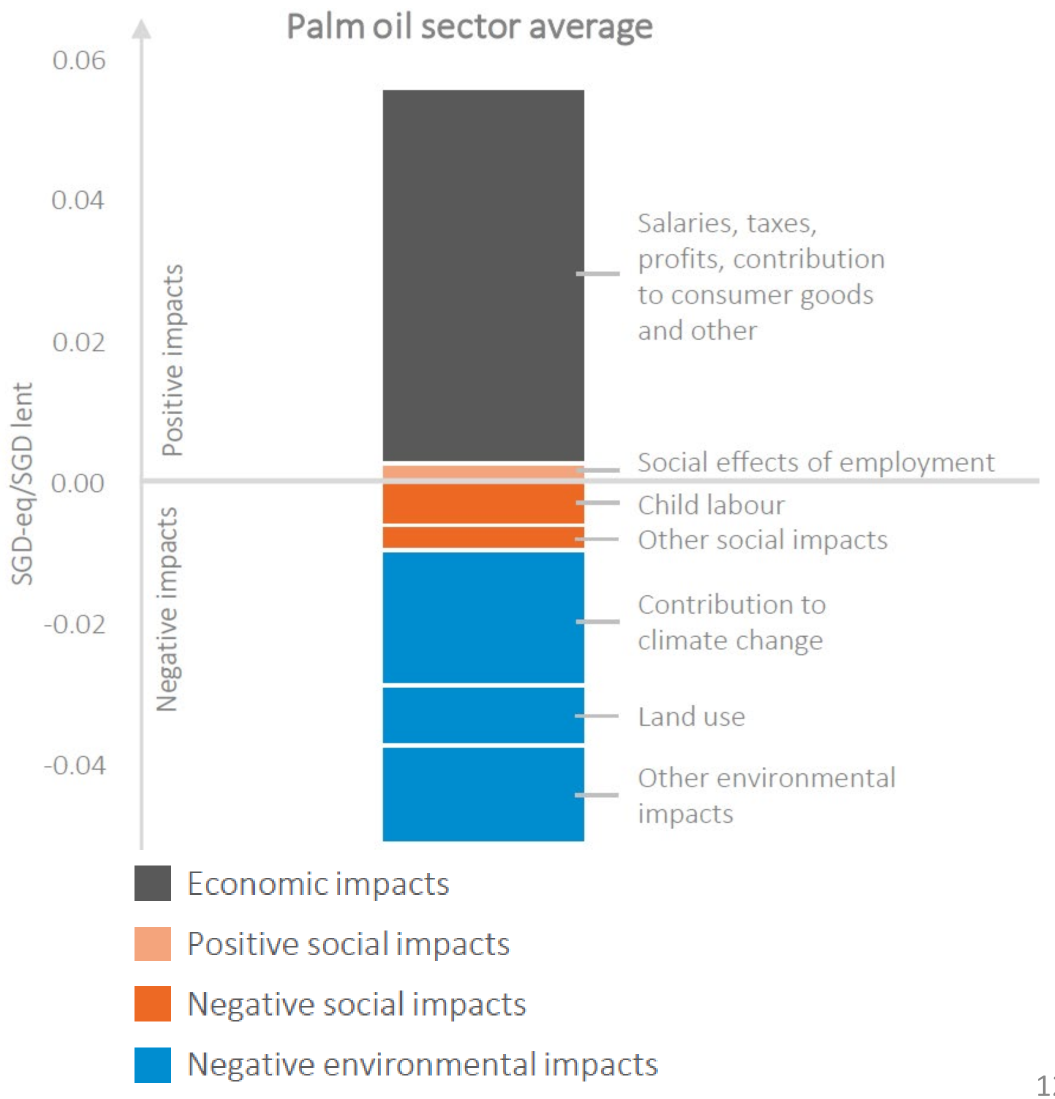
- Public equity, usually of index companies (e.g., MSCI World Index, FTSE 100, Russell 2000)
- ESG reporting usually output or input focused
- Use different metrics for different E, S, G dimensions
- Either in letter grades (e.g., D- to A+, or CCC to AAA) or in percentile rank scores (e.g., 0-100, with mean 50)
- Usually provided by third party agencies
- Used for portfolio construction by asset owners/managers

Impact Measurement

- Public equity, private equity, project, debt, real assets
- Not about intention, input or output, but about the effect or outcome
- Can be quantified, valued, and aggregated (in monetary units)
- Direct vs. indirect impact; absolute vs. marginal impact
- No data providers; done by investors/managers themselves
- Usually no standard metrics and rating agencies, so we need some standardized frameworks!

Impact Measurement: Lending to the Palm Oil Sector





Source: https://www.dbs.com/sustainability/insights/measuring-impact

With the increasing number of Impact Frameworks, a question still stands: how can organisations take control over their impacts and provide transparency to their stakeholders?

Impact Institute is proud to announce we have joined forces with Harvard Business School, Singapore Management University, and Impact Economy Foundation to create an Impact-Weighted Accounts Framework (IWAF).

The goal of our collaboration is to bring forward a publication that incorporates the newest ideas on impact measurement and valuation from around the globe. The consultation version is due in summer. Stay tuned!

We appreciate the work of our contributors Rob Zochowski, Hao Liang, Eszter Vitorino Fuleky, Willem Schramade, Reinier de Adelhart Toorop, Adrian de Groot Ruiz and Valerius Hartanto and the Board Members and Academic Council members of Impact Economy Foundation.

Find out more at https://lnkd.in/dhKREzF

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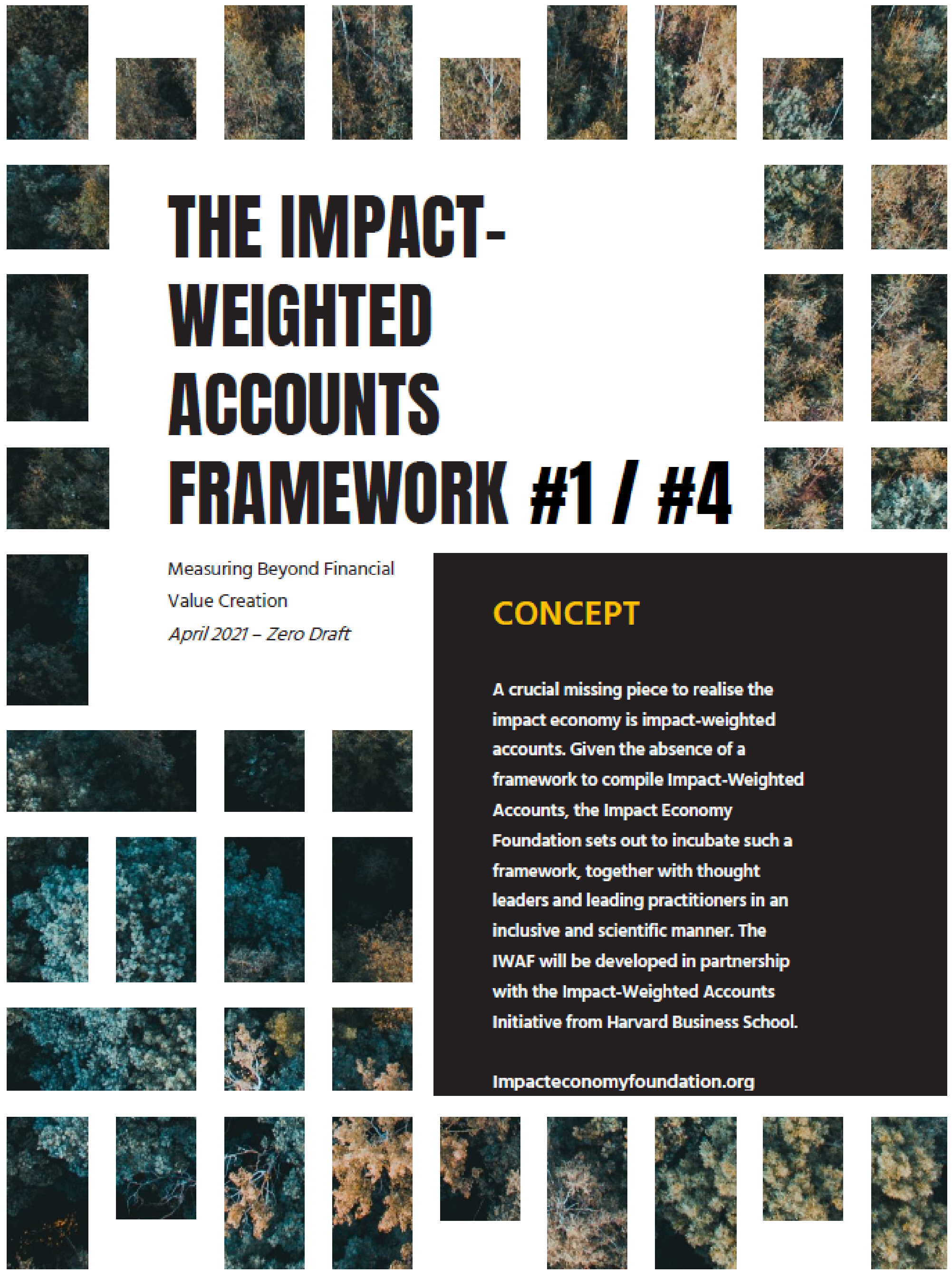

THE IMPACT-WEIGHTED ACCOUNTS FRAMEWORK #1 / #4

Measuring Beyond Financial Value Creation

April 2021 – Zero Draft

CONCEPT

A crucial missing piece to realise the impact economy is impact-weighted accounts. Given the absence of a framework to compile Impact-Weighted Accounts, the Impact Economy Foundation sets out to incubate such a framework, together with thought leaders and leading practitioners in an inclusive and scientific manner. The IWAF will be developed in partnership with the Impact-Weighted Accounts Initiative from Harvard Business School.

Impacteconomyfoundation.org