A Critical Lens on ESG and ESG Ratings

CS Gilbert Kiprono & Hosea Mutwiri

Abstract

This article examines the importance of ESG (Environmental, Social, and Governance) and why it matters. Aligned with the theme of the 27th Annual Conference of the Institute of Certified Secretaries (ICS), titled "ESG for a Sustainable Future: Aligning People, Planet, and Profit," the article explores the criticisms of ESG, categorizing them into four main points. These include: the argument that ESG is not desirable, as it can be a distraction; the assertion that ESG is not feasible due to inherent difficulties; the belief that ESG cannot be effectively measured; and the claim that even when ESG can be measured, there is no meaningful correlation with financial performance. The article concludes by examining the relationship between ESG ratings and financial performance. Existing literature presents conflicting findings on various aspects of ESG, including criticisms of ESG itself, as well as the link between ESG ratings and financial performance.

Introduction

ESG, which stands for environmental, social, and governance, has gained significant traction in recent years. The importance of ESG is evident in the increasing number of internet searches and the growing adoption of ESG reporting by companies. Over 90% of S&P 500 companies and 70% of Russell 1000 companies now publish ESG reports[1]. The rise of ESG can also be seen in the investment landscape, with sustainable funds experiencing significant inflows. Global sustainable assets reached $2.5 trillion in mid-2022[2].

In light of the conflict in Ukraine and its far-reaching consequences, critics have raised doubts about the long-term significance of ESG[3]. They argue that attention will shift towards more fundamental elements of societal and economic needs, relegating ESG to a passing trend[4]. Additionally, some contend that ESG's combination of factors is unstable and that the focus should solely be on environmental sustainability[5]. Alongside these concerns, challenges to the integrity of ESG investing have emerged. However, this article focuses on the individual company level, examining whether ESG truly matters to businesses and the strategic rationale behind its adoption.

A critical lens on ESG

Criticisms of ESG are not new. As ESG has gone mainstream and gained support and traction, it has consistently encountered doubt and criticism as well. The main objections fall into four main categories.

1 Sustainability reporting in focus, G&A Institute, 2021.

2 Global Sustainable Fund Flows, 2022

3 Simon Jessop and Patturaja Murugaboopathy, "Demand for sustainable funds wanes as Ukraine war puts focus on oil and gas," Reuters, March 17, 2022; Peggy Hollinger, "Ukraine war prompts investor rethink of ESG and the defence sector," Financial Times, March 9, 2022

4 Bérengère Sim, "Ukraine war 'bankrupts' ESG case, says BlackRock's former sustainable investing boss," Financial News, March 14, 2022.

5 See, for example, "ESG should be boiled down to one simple measure: emissions," Economist, July 21, 2022

1. ESG is not desirable, because it is a distraction

According to critics, one of the main objections to ESG is that it is viewed as a distraction from the core purpose of businesses, which is to maximize profits while adhering to societal rules[6]. They argue that ESG practices are often seen as a public relations move or a way to capitalize on the values of customers, investors, or employees. Critics claim that ESG is not foundational to company strategy and is seen as something "good for the brand" rather than essential[7]. Some critics even label ESG efforts as "greenwashing," "purpose washing," or "woke washing," implying that companies may not genuinely prioritize sustainability, ESG, or diversity, equity, and inclusion (DEI) commitments[8]. A survey by Edelman[9] revealed that nearly three out of four institutional investors do not trust companies to fulfill their sustainability, ESG, or DEI commitments.

2. ESG is not feasible because it is intrinsically too hard

A second critique of ESG is that implementing it in a way that resonates with multiple stakeholders is challenging. The objective of maximizing value for the corporation and shareholders is clear when solving for a financial return. However, when considering broader objectives and complex solutions, trade-offs arise. Managers face the dilemma of deciding where to allocate the incremental ESG dollar; should

6 Milton Friedman, "The social responsibility of business to increase its profits," New York Times Magazine, September 13, 1970

7 Say-on-climate votes are generally nonbinding resolutions submitted to shareholders (similar to "say-on-pay" resolutions), which seek shareholder backing for emissions reductions initiatives. See, for example, John Galloway, "Vanguard insights on evaluating say on climate proposals," Harvard Law School Forum of Corporate Governance, June 14, 2021.

8 Say on climate: Investor distraction or climate action?," blog post by Florian Sommer and Harlan Tufford, MSCI, February 15, 2022.

9 Special report: Institutional investors, Edelman Trust Barometer, 2021.

it go towards lower prices for customers, increased benefits or higher wages for employees, or addressing environmental issues through an internal carbon tax? The optimal choice is often unclear, and even if it existed, companies may lack a clear mandate from shareholders to prioritize ESG.

3. ESG is not measurable, at least to any practicable degree

A third objection raised by critics is the difficulty in accurately measuring ESG, especially when it comes to aggregate ESG scores. While individual dimensions of E, S, and G can be assessed if the required, auditable data is available, critics argue that overall ESG scores lack meaningfulness. This is due to differences in weighting and methodology among ESG ratings and scores providers. For instance, credit scores from S&P and Moody's show a 99% correlation, whereas ESG scores from six prominent providers have an average correlation of only 54%, ranging from 38% to 71%[10]. Additionally, organizations like the GRI and SASB may measure the same phenomenon differently. Different providers, incorporating their own analyses and weightings, naturally result in divergent scores. Major investors often rely on their proprietary methodologies, which include inputs from various sources, including ESG scores, honed over time.

4. Even when ESG can be measured, there is no meaningful relationship with financial performance

According to critics, positive correlations between ESG and outperformance may be explained by other factors and

10 Florian Berg, Julian Kölbel, and Roberto Rigobon, "Aggregate confusion: The divergence of ESG ratings," Review of Finance, forthcoming, updated April 26, 2022.

are not necessarily causative. It would be unreasonable to expect near-identical ESG ratings across different providers, methodologies, and industries to perfectly match company performance. Correlations with performance can be influenced by various factors such as industry trends and may change over time[11]. While most ESG-focused investment funds tend to outperform the broader market, some ESG funds do not, and alternative explanations for outperformance exist[12]. For example, technology and asset-light companies often score higher in ESG ratings due to their lower carbon footprint. Several studies have questioned any causal link between ESG performance and financial performance[13]. However, companies are still making significant decisions and commitments aligned with ESG considerations, indicating their growing importance in decision-making.

ESG ratings

The extent to which ESG, as measured by ratings, can offer meaningful insights about future financial performance is one of the most hotly contested issues surrounding environmental, social, and governance (ESG)—particularly when ratings and scores providers use various, and occasionally conflicting, methodologies. According to several research, there is a link

11 See, for example, James Mackintosh, "Credit Suisse shows flaws of trying to quantify ESG risks," Wall Street Journal, January 17, 2022.

12 See, for example, Chart of the Week, "Does ESG outperform? It's a challenging question to answer," blog post by Raymond Fu, Penn Mutual, September 23, 2021; Gregor Dorfleitner and Gerhard Halbritter, "The wages of social responsibility—where are they? A critical review of ESG investing," Review of Financial Economics, Volume 26, Issue 1, September 2015.

13 See, for example, Chart of the Week, "Does ESG outperform? It's a challenging question to answer," blog post by Raymond Fu, Penn Mutual, September 23, 2021; Gregor Dorfleitner and Gerhard Halbritter, "The wages of social responsibility—where are they? A critical review of ESG investing," Review of Financial Economics, Volume 26, Issue 1, September 2015.

between financial performance and ESG ratings[14]. According to other studies, while achieving high ESG ratings does not result in the destruction of financial value, the connection between ESG ratings at any particular time and value creation at that same time may be contentious or nonexistent[15].

Conclusion

While the relevance of ESG and its impact on financial performance continues to be a subject of debate, there is a growing recognition of the importance of ESG considerations in their strategic and decision-making processes. Companies are facing increasing pressure from various stakeholders to prioritize sustainability, social responsibility, and good governance. Despite the challenges in measuring and assessing ESG factors, companies are making significant commitments aligned with ESG, indicating their recognition of the importance of these considerations in today's business landscape.

14 Florian Berg, Julian Kölbel, and Roberto Rigobon, "Aggregate confusion: The divergence of ESG ratings," Review of Finance, forthcoming, updated April 2022; Ulrich Atz, Casey Clark, and Tensie Whelan, ESG and financial performance: Uncovering the relationship by aggregating evidence from 1,000 plus studies published between 2015–2020, NYU Stern Center for Sustainable Business, 2021

15 2 See Chart of the Week, "Does ESG outperform? It's a challenging question to answer," blog post by Raymond Fu, Penn Mutual, September 23, 2021; Giovanni Bruno, Mikheil Esakia, and Felix Goltz, "'Honey, I shrunk the ESG alpha': Risk-adjusting ESG portfolio returns," Journal of Investing, April 2022.