

EXCLUSIVE

Pro-business group suggests ESG ratings fall short of identifying risk

Friday, 20 July 2018 1:43 PM ET By Esther Whieldon

A new paper by the American Council for Capital Formation suggests the methods ratings organizations use to score corporations on their environmental, social and governance activities and efforts to address related risks have significant shortfalls.

The council, or ACCF, a Washington, D.C.,-based pro-business group, is a member of the Main Street Investors Coalition that is [pushing back](#) against the tide of shareholders and asset managers pressing corporations around the world to adopt and disclose ESG measures. Investors use ESG metrics to gauge how a company is positioned to address challenges such as climate change, gender diversity, and other social expectations and issues that are not traditionally part of a company's financial risk assessment. And investors are increasingly factoring companies' ESG ratings into investment decisions and strategies.

The [paper](#) "Ratings that Don't Rate: The Subjective World Of ESG Ratings Agencies" by Timothy Doyle of the ACCF suggests investors should not assume a company's high ESG rating automatically means it is a less risky investment. The paper mentions a number of organizations in this regard, including [MSCI Inc.](#), [Sustainalytics U.S., Inc](#) and [RepRisk AG](#).

Organizations that provide company ESG ratings fail to identify whether companies are addressing risks and instead offer platforms for bigger companies to make themselves look more robust than might be the case, Doyle said. Contributing to this problem, according to Doyle, is a heavy bias in the ratings toward companies that publicly disclose their policies and practices, and a lack of consistency among ratings agencies in how they determine company scores, which sometimes results in the same company being assigned significantly different scores.

For example, RepRisk gave [Bank of America Corp.](#) a below average score at the same time as Sustainalytics assigned the bank a well above average score. And RepRisk gave construction material manufacturer [USG Corp.](#) an above average rating while Sustainalytics ranked the company below average, the ACCF report said.

The paper said other challenges include a lack of uniformity in how companies disclose their information, and the use of one-size fits all industry weightings that skew the results by ignoring company-specific risks.

From ACCF's perspective, the shortfalls in ESG ratings practices disadvantages smaller companies that do not have the money or resources to spend a lot of time on ESG disclosures or on deciding how to frame their answers to questionnaires in a way that will make them look more robust, Doyle said in a July 19 interview.

"Smaller companies are penalized right out of the gate because they don't have the resources to do it," Doyle said. He noted that some industries are working to standardize company disclosures.

Sustainalytics and MSCI did not respond to a request for comment. But RepRisk in a July 20 emailed statement said that, while it shares many of the ACCF report's concerns about ratings, RepRisk does not consider itself to be a ratings agency.

RepRisk said it an ESG data firm that specializes in helping its clients, including investors, look at ESG and business conduct risks. Also, RepRisk said that unlike some other organizations mentioned in the ACCF report, RepRisks' assessments do not give weight to how much a company discloses but rather the firm looks at how a company is performing where it operates.

RepRisk said it has captured high ESG risk exposure in the past for [Wells Fargo & Co.](#), [Volkswagen AG](#) and for [BP PLC](#) before the April 2010 Deepwater Horizon oil spill occurred.

That said, RepRisk agreed with Doyle there are fundamental problems with ESG ratings. The target of the ratings is often unclear and, because the terms ESG and sustainability are very subjective, the lack of consistency and transparent methodology in some organizations "is also a problem." RepRisk said it is open about its methodology.

The firm also agreed that weighting ESG subfactors at the company and industry levels are arbitrary and do not reflect material risks because it leaves room for companies to "compensate for material risks by scoring higher in other areas."