The Legitimacy of ESG Rating Agencies

An Interdisciplinary Perspective

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Abstract

Environmental, social and governance (ESG) rating agencies play a crucial economic and political role in the rise of sustainable investments. However, there are concerns that ESG rating agencies lack legitimacy for executing this role. This research introduces an interdisciplinary framework which is used to evaluate the legitimacy of ESG rating agencies. To evaluate the relevance and completeness of this interdisciplinary framework, and to explore the presence of legitimacy challenges for ESG rating agencies, seven semi-structured interviews with asset managers and experts are held. Based on these interviews, it is concluded that, from an interdisciplinary perspective, the legitimacy of ESG rating agencies can be researched by evaluating their (1) acceptance, (2) expertise, (3) transparency, (4) conflict of interest, (5) reputation costs, (6) monitoring, and (7) congruence with social objectives. The legitimacy of ESG rating agencies is mainly challenged due to a lack of transparency, reputation costs, monitoring processes, and conflict with social objectives.

Lessons for Practice

- The legitimacy of ESG rating agencies is mainly threatened by a lack of transparency, reputation costs, monitoring process and incongruence with social objectives.
- The legitimacy of ESG rating agencies could be significantly improved by enhancing installing (public) monitoring processes.
- ESG ratings are not necessarily used for, and thereby not developed for, having a positive ESG impact on the world, but are rather used to minimize financial damage due to ESG events.

Keywords: sustainability, legitimacy challenges, ESG rating agencies

Introduction

In 2015, 196 countries signed the Paris Agreement: a legally binding international treaty on climate change (United Nations Framework Convention on Climate Change, 2022). By signing this treaty, it has been globally recognized that climate change is a global problem, and that to overcome this problem, global cooperation is required (Park, 2018). In order to finance the set climate goals, Busch et al. (2016), Folqué et al. (2021), and Park (2018) argue that a reorientation within the financial system towards a long-term sustainable finance paradigm is necessary.

Environmental, social and governance (ESG) rating agencies play a crucial economic and political role in the rise of sustainable investments.

Since the Paris Agreement, a reorientation towards a more sustainable investment paradigm has been noticed (Chen & Zhao, 2021). Between 2016 and 2020, global sustainable investments increased from 22,8 trillion USD to 35,3 trillion USD in the regions Europe, United States, Canada, Australia, and Japan (Global Sustainable Investment Alliance [GSIA], 2020). Generally, sustainable investing is defined as an investment approach where environment, social and governance (ESG) factors are considered in the portfolio selection and management (GSIA, 2020). ESG factors can be integrated in the portfolio selection and management by using ESG products that are created by ESG rating agencies (Kölbel et al., 2020). ESG rating agencies are companies that assess corporate sustainability performance with their own ESG research methodology (Escrig-Olmedo et al., 2019). Consequently, ESG rating agencies are in a position to determine how to define and measure corporate sustainability performance (Cunha et al., 2020). In European Union (EU) legislation about sustainable finance, ESG products also play a significant role in helping to measure corporate sustainability performance (European Commission [EC], 2022; EU, 2019). This way, ESG products are institutionalised by the EU as a way of measuring corporate sustainability performance. In other words, ESG rating agencies have gained legitimacy to determine how to define and measure corporate sustainability performance.

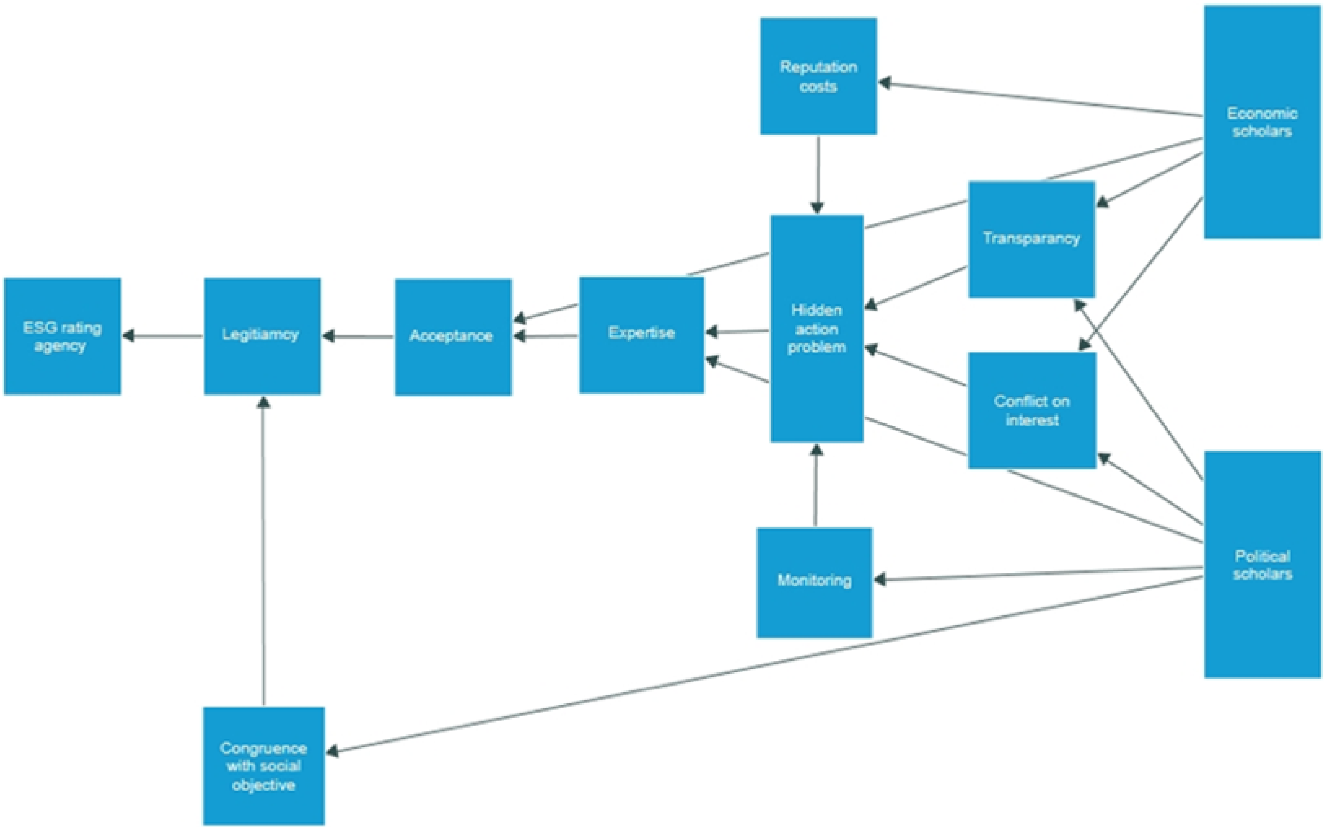
Giving legitimacy to private actors can help solving societal problems (Berstein & Cashore, 2017). However, in the case of ESG rating agencies, their legitimacy position is challenged. ESG rating agencies are being criticized for a for a lack of transparency (see Abhayawansa & Tyagi (2021) and Becker et al. (2022)), lack of quality (see Berg et al. (2022) and Chatterji et al. (2016)), and problems related to their independence (see Avetisyan & Hockerts, 2017 and Autoriteit Financiële Markten (2020)). For these reasons, this research seeks to evaluate the legitimacy of ESG rating agencies to determine how to define and measure corporate sustainability performance.

Theoretical framework

In this research, Bernstein's (2005) definition of legitimacy is used. Bernstein (p. 142) defines legitimacy as "the acceptance and justification of shared rule by a community". When asset managers contract ESG rating agencies and when the EU refers to ESG factors in their financial policies, a shared rule is created and defined as giving ESG rating agencies a mandate to determine how to define and measure corporate sustainability performance. In order to evaluate the acceptance and justification of shared rule, an interdisciplinary approach is used.

As seen in Figure 1, based on integrated economic and political science perspectives, the following seven factors are distinguished and used to evaluate the legitimacy of ESG Rating agencies: (1) acceptance, (2) expertise, (3) transparency, (4) conflict of interest, (5) reputation costs, (6) monitoring mechanisms, and (7) accordance with social objectives. Afterwards, these factors have been analysed by conducting seven semi-structured interviews with Dutch asset managers and economic/political experts.

Figure 1. *Evaluating legitimacy from an interdisciplinary perspective*



Results

Based on the interviews, it is concluded that the legitimacy of ESG rating agencies is mainly challenged by a lack of (3) transparency, (5) reputation costs, (6) monitoring processes, and (7) incongruence with social objectives. The (3) transparency given by ESG rating agencies is limited since, especially smaller asset management firms, indicate that they do not have access to, or fail to understand the methodology used to collect ESG data and create ESG ratings. Additionally, ESG rating agencies have (5) low reputation costs. The lack of transparency harms comparability and makes it difficult to measure quality. Moreover, a few ESG rating agencies have an oligopoly and take smaller ESG rating agencies which enter the market over. Therefore, they are only to a limited extent controlled by the market, since buyers of ESG products have no proper alternatives. Furthermore, it has been concluded that no (6) structural public monitoring processes have been installed. The combination of the lack of transparency, reputation costs, and monitoring raises concerns about the quality assurance of ESG products and challenges the legitimacy of ESG rating agencies. Notwithstanding these challenges, another threat to the legitimacy of ESG rating agencies is (7) discrepancy between a social desire to have ESG ratings which measure companies' ESG impact on the world, and the reality of ESG ratings which measure the impact of ESG events on companies' financial performance. For this reason, a high ESG score, does not necessarily entail that the respective company is sustainable, and therefore, does not serve the social objective of financing sustainable companies.

Conclusion and further research

ESG rating agencies play, and most likely will play, a fundamental role in making the financial sector more sustainable. Due to the lack of transparency, reputation costs and (public) monitoring processes, the quality of ESG products is under pressure, and thereby, challenges the legitimacy of ESG rating agencies. Therefore, it is recommended to study how these factors can be improved by, for example, installing public or private institutions that monitor quality processes. Additionally, there is a difference between using ESG ratings to limit ESG based (financial) risk, or using them to create a positive societal impact. Whilst the first is more common, the latter is, from a social perspective, a reason for granting ESG rating agencies legitimacy. Therefore, the legitimacy of ESG rating agencies to define and measure corporate sustainability performance is, from an interdisciplinary perspective, strained.

A note from the author

My name is Stijn Scholten. I studied Philosophy, Politics and Economics with the objective of better understanding complex societal challenges. With this and further research, I seek to contribute to solutions of today's challenges. One challenge is how to globally accelerate a just climate transition. In order to accelerate this transition, more solution-based knowledge is necessary. Therefore, I am currently, as a project manager at the Dutch Association of Investors for Sustainable Development (VBDO), researching challenges and opportunities to accelerate a just climate transition. I am honoured to publish my research in Public Note, and I hope it inspires others to further contribute to solving today's challenges. I cannot do it alone, but we can do it together.

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