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RESEARCH BRIEF

Do Commercial Ties Influence ESG Ratings? Evidence from Moody's and S&P

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In recent years, regulators and academics have raised significant concerns about the reliability of ESG (environment, social, and governance) ratings.

This study provides the first evidence that conflicts of interest arising from commercial ties among rating agencies lead to bias in ESG ratings.

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SUMMARY OF FINDINGS

Exponential growth in sustainable investing has motivated traditional financial-services firms to expand into the ESG-rating arena. In this context, credit-rating agencies (CRAs) that typically have conflicts of interest due to their issuer-pay model have moved into ESG-rating by acquiring ESG-rating providers. These acquisitions give rise to new conflicts of interest and a critical question: Do CRAs give their credit-rating clients higher ESG ratings?

The authors seek to answer this question by examining changes in commercial ties resulting from Moody's acquisition of Vigeo Eiris and S&P's purchase of the ESG rating arm of RobecoSAM, to understand how such ties affect ESG ratings. Post-acquisition, existing Moody's and S&P credit-rating clients become indirect clients of the ESG-rating agencies via the ESG-raters' parent companies. Thus, the new commercial ties may lead ESG-rating agencies to curry favor with their parent companies' credit-rating clients. Understanding how ESG ratings are affected by such economic incentives is important because ESG ratings direct trillions of dollars of fund flows and investors pay premiums for shares of firms with high ESG scores.

The research reveals four main insights:

- Firms with existing credit-rating business with Moody's and S&P receive higher ESG ratings than those that do not.
- Firms with more intensive credit-rating relationships with Moody's and S&P enjoy a stronger increase in ESG ratings, whereas firms with more transparent ESG disclosures and higher long-term institutional holdings experience less ESG-rating inflation.
- The biased ESG ratings help client firms issue more green bonds and help Moody's and S&P maintain credit-rating business.
- The quality of ESG ratings appears to deteriorate as the upwardly biased ESG ratings are less informative of future ESG news.

These findings have regulatory implications and have been cited in a proposal of EU ESG-ratings regulation.

Credit Ratings Versus ESG Ratings

A credit rating is an assessment of creditworthiness of a firm or debt security, whereas an ESG rating is an assessment of a firm's exposure to environmental, social, and governance risks. The credit-rating business is highly regulated, and dominated by three players—Moody's, S&P, and Fitch. In contrast, the more nascent ESG-rating business is unregulated.

Furthermore, although the quality of credit ratings is observable through their relation to bond yields or credit default spreads, ESG-rating quality is difficult to verify. Together, these factors suggest ESG ratings might be more easily manipulated than credit ratings.

CRA Acquisition of ESG-Rating Agencies

In April 2019, Moody's announced acquisition of a majority stake in leading international ESG-rating agency Vigeo Eiris. Later that year, S&P Global acquired the ESG-rating arm of RobecoSAM, escalating an arms race with Moody's.

In general, CRA acquisitions of ESG-rating agencies could foster synergies in the credit- and ESG-rating businesses, given similarity between CRA and ESG-rating agency roles as information intermediaries. But these acquisitions could also create potential conflicts of interest, as CRAs assign credit ratings and ESG ratings to the same firms. Although ESG ratings are paid for mostly by investors who use them, credit ratings are paid for by the firms being rated, which creates incentives for CRAs to cater to these credit-rating clients, as prior literature documents. Given such incentives, CRAs may favor existing credit-rating clients and pressure their newly acquired ESG subsidiaries to assign higher ESG ratings to these clients.

Evidence of ESG-rating Inflation

The authors study pre- and post-acquisition patterns in ESG ratings to find that ESG-rating agencies assign higher ESG ratings to firms with existing credit-rating relationships with their parent CRA—based on observations of over 25,000 ratings total. Specifically, post-acquisition ESG ratings of existing credit-rating clients of Moody's and S&P increase by 17.16% of the standard deviation of the ESG ratings from peer rating agencies Refinitiv, MSCI, and Sustainalytics.

Moreover, firms with deeper credit-rating business relationships with CRAs tend to receive more favorable ESG ratings. Interestingly, transparent ESG disclosures and high long-term institutional holdings help mitigate ESG-rating inflation, possibly due to higher risk of detection of inflation under a transparent information environment and institutional monitoring.

The Benefits of ESG Rating Inflation

For ESG-rating favoritism to work, such inflation must benefit client firms. In recent years, there has been growing demand for green bonds in the financial market. Higher ESG ratings can facilitate the issuance of green bonds with lower cost of capital. The authors find that after CRA acquisition of ESG-rating agencies, inflated ESG ratings help existing credit-rating clients issue more green bonds at lower cost.

What, then, are the benefits for CRAs that inflate ESG ratings? The authors demonstrate that higher ESG ratings help CRAs maintain and (marginally) attract more credit-rating business from client firms.

The Last Piece of Puzzle: ESG-Rating Quality Declines

CRAs can obtain private information from client firms through their interactions in the credit-rating process, which could be useful when their new subsidiaries assign ESG ratings. If this is the case, ESG-rating quality should increase post-acquisition. However, the authors find that informativeness of ESG ratings for future ESG news appears to decline post-acquisition, suggesting that ESG-rating inflation compromises ESG-rating quality.

Overall, the authors find compelling evidence that ESG ratings for clients of credit-rating agencies become biased after the agencies acquire ESG-rating subsidiaries, with meaningful implications for multiple stakeholder groups.

KEY DATA

- ESG ratings from Moody's, S&P, Refinitiv, MSCI, and Sustainalytics
- Credit ratings from Moody's and S&P

PRACTICAL IMPLICATIONS

- *Regulators have been right to be concerned about potential conflicts of interest arising from ESG-rating agencies' business relationships and should shape regulations to mitigate these.*
- *Investors and the broader public should be made aware of these new conflicts of interest and their potential economic effects. Greater awareness of the negative consequences of ESG-rating bias could deter this rating-agency behavior.*
- *Financial services firms can mitigate the conflicts of interest by providing more disclosure and assurance of the independence of their ESG ratings from other business lines.*

QUESTIONS FOR FUTURE RESEARCH

On the mechanism behind ESG-rating inflation:
How exactly do CRAs bias client firms' ESG ratings? Do they use their discretion within the ESG-rating methodologies or adjust these rating methodologies?

On consolidation of the ESG-rating industry:
Does the shift in the competitive landscape of ESG-rating agencies due to consolidation affect the quality of their ESG ratings?