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A SCHOLARLY investigation has found a positive correlation between the environmental, social and governance (ESG) scores given to companies by Moody's and S&P, and their status as paying clients of the ratings agencies.

The researchers from the Singapore Management University (SMU) were careful to caveat their findings are still preliminary, but the correlation suggests score inflation can't be ruled out and that there is a need to carefully manage conflicts of interest.

The study also found that the increase in scores was more pronounced for companies that disclosed relatively less information on their ESG performance, which the researchers said could have made it easier for manipulation to take place.

When reached for comment, Moody's and S&P dismissed the notion that they had intentionally inflated the ESG scores of their credit rating clients.

A Moody's spokesperson told *The Business Times* the agency's ESG assessments are "independent" from its credit ratings. "We have extensive safeguards in place to protect the independence and integrity of both our ESG assessments and credit ratings," she added.

A spokesperson from S&P Global said: "S&P Global is committed to the independence and objectivity of its products and services, and has policies in place to help maintain an appropriate separation between the different business units, including S&P Global Sustainable which develops S&P Global ESG Scores."

The working paper, which was

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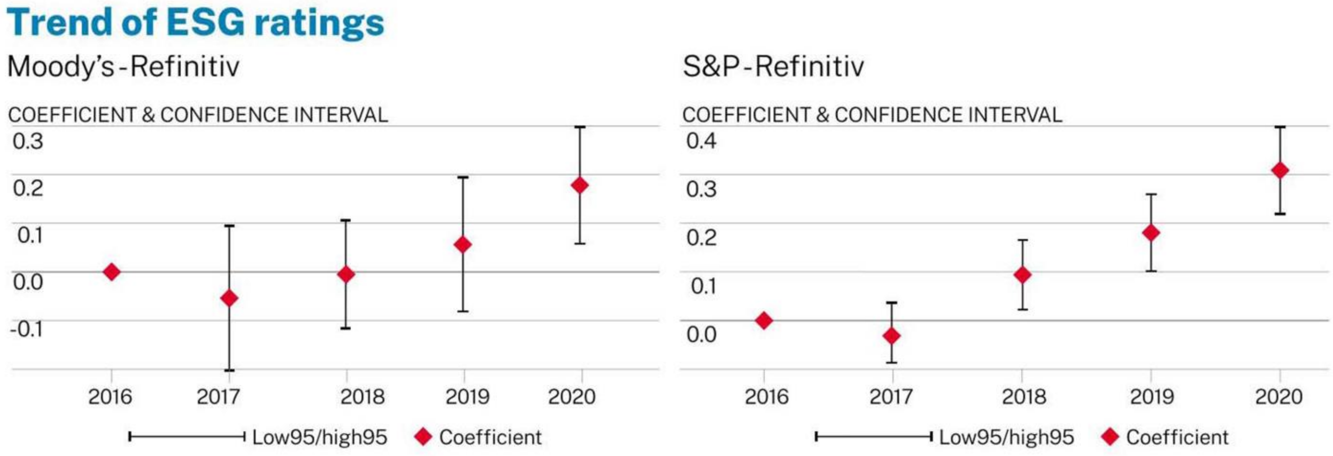

Source: Li Xuanbo, Lou Yun and Zhang Liandong

presented and discussed at the inaugural Nanyang Business School Accounting Conference on Thursday (May 19), was co-authored by SMU PhD student Li Xuanbo, associate professor Lou Yun, and professor Zhang Liandong.

The researchers were interested in the potential conflicts of interest arising from a consolidation of the ESG rating space in recent years. Between 2017 and 2019, there were 11 acquisitions. Acquirers included Morningstar and Sustainalytics as well, they noted.

Moody's acquired a majority stake in Vigeo Eiris, a leading international ESG rating agency, in April 2019; and S&P acquired the ESG ratings arm of RobecoSAM, a Swiss asset manager, in November 2019.

"While these acquisitions were driven by investors' demand for more ESG information, they could also lead to conflicts of interest for financial-services firms that have multi-business lines and struggled to manage conflicts of interest in the past," the researchers said.

Inflated bond ratings were identified as one of the causes of the 2007-2008 financial crisis, and the Big 3 credit ratings agencies – Moody's, S&P, and Fitch – had previously come under fire for giving overly-optimistic ratings in a fight for market share.

The SMU researchers noted as well that while the quality of credit ratings is measurable and observable to the debt market, the quality of ESG ratings is hard to judge due to the variance in categories, measurements and weights used in scoring. The credit ratings business is also highly regulated, whereas ESG scoring is still in its infancy and unregulated.

There is, therefore, more room for manipulation in the ESG space as the cost of doing so is "much lower".

The researchers based their findings on an analysis of the ESG ratings issued by Vigeo Eiris and RobecoSAM before and after they were acquired by Moody's and S&P respectively, from 2016 to 2020.

Their Moody's sample contained 10,961 observations from 4,124 companies across the globe, while the sample for S&P comprised 16,909 observations from 4,066 companies globally.

Companies that conducted credit ratings business with Moody's experienced a 1.287-point increase in ESG ratings after the acquisition – about 4 per cent higher than the agency's average.

Companies with existing credit rating dealings with S&P, on the other hand, experienced a 1.997-point increase in ESG ratings after the acquisition – 6.7 per cent higher than the agency's average.

Speaking to BT, SMU's Lou stressed that the findings are preliminary and still subject to changes. She and her team will be updating the analyses by incorporating newer data. She added that while the results presented are based on economic analyses, the analyses cannot completely rule out the possibility that the increase in ESG ratings for affected companies is due to the positive synergies of Moody's and S&P's acquisitions of ESG rating agencies, rather than intentional ESG rating inflation.

"In fact, in our paper, we acknowledge that the consolidation of credit rating and ESG rating agencies could also be beneficial for capital markets: It creates synergies in the two business lines via information and resource sharing, which potentially helps improve the quality of ESG ratings," she said.

The researchers did, however, benchmark the Moody's and S&P's ESG scores against scores issued by Refinitiv. This was done to rule out the hypothesis that the scores of these companies improved because of inherent improvements in their ESG performance.

The researchers also found a correlation between the quantum of increase in ESG ratings and the strength of the credit ratings relationship. And, ESG scores became tougher to predict after the acquisitions.

Given the findings, the researchers said investors should be aware of potential conflicts of interest when they use ESG ratings to guide their investments.

"The public awareness of the conflicts of interest and their negative consequences (in terms of biased ESG ratings) can have a deterrence effect on the behaviour of credit ratings agencies," they said.

Regulators, meanwhile, "may need to match the growing demand for ESG ratings with appropriate regulations to ensure the rating quality and reliability".

This could mean using existing regulatory frameworks associated with credit rating agencies to increase supervision over the agencies' newly acquired ESG rating business, they said.

Meanwhile, they said financial services companies can mitigate conflicts of interest by providing greater disclosure and assurance of the independence of their ESG ratings from other business lines.