# EDITORIAL: The future research of the ESG rating

*Dear readers!*

The proliferation of sustainable and responsible investment (SRI) has led investors to favor socially responsible companies (Galbreath, 2013; Avetisyan & Hockerts, 2017). This has contributed to the growing importance of environmental, social, and governance (ESG) ratings, and ESG rating agencies have established themselves as a primary source of information for businesses, financial markets and academia (Diez-Cañamero, Bishara, Otegi-Olaso, Minguez, & Fernández, 2020). Investors blindly rely on ESG ratings when making investment decisions (Rzeźnik, Hanley, & Pelizzon, 2021) and funds investment communities that invest in ESG-rated securities have registered significant inflows (Hartzmark & Sussman, 2019), particularly after COVID-19. As a result, ESG ratings can exert greater influence on financial decisions, with potentially far-reaching implications for asset prices and policies. For these reasons, the responsibility of ESG rating agencies concerns society as a whole and goes far beyond the sphere of financial markets (Escrig-Olmedo, Fernández-Izquierdo, Ferrero-Ferrero, Rivera-Lirio, & Muñoz-Torres, 2019). Negative results in terms of ESG ratings impact on the reputation of companies with the related consequent effects. Think about when KLD eliminated Coca-Cola Co. from its Broad Market Social Index in 2006 or Tesla's current situation.

The agreement generalized on the importance of ESG investment has a limit in the wide measurement divergence between different providers. The ESG ratings provided from the different rating agencies are many remarkably different cases (Chatterji, Durand, Levine, & Touboul, 2016; Billio, Costola, Hristova, Latino, & Pelizzon, 2021; Berg, Kölbel, & Rigobon, 2022). It is widely documented in academic studies that ESG ratings for the same company often differ widely between rating agencies (Chatterji et al., 2016; Semenova & Hassel, 2015) and correlations between the various ESG ratings are generally low (Christensen, Serafeim, & Sikochi, 2022). All this has been quite evident, especially in recent years. The chairman of the US Securities and Exchanges Commission (SEC) has publicly questioned the quality of ESG ratings and criticized their accuracy, and the European Commission is looking for ways to improve their oversight. The International Organization of Securities Commissions (IOSCO) and the Securities and Exchange Board of India (SEBI) are pushing for regulation of ESG rating providers, especially with regard to transparency and disclosure of ESG rating methodologies.

Each rating agency uses its own methodology (Delmas & Blass 2010; Hedesström, Lundqvist, & Biel, 2011). For this reason, their assessments differ in the level of detail with which information is assessed, in identifying important factors, where the data is generated from, and how factors are measured and weighted. Each rating agency measures the three pillars E, S and G through a series of indicators (Al Farooque, Dahawy, Shehata, & Soliman, 2022; Grove, Clouse, & Xu, 2022). The lack of standardized rules and the subjective nature of ratings makes it difficult to obtain comparable results that often diverge significantly (Chatterji et al., 2016; Billio et al., 2020; Berg, Kölbel, Pavlova, & Rigobon, 2021). In addition to the high level of subjectivity and interpretation, ESG ratings lack transparency on how information is valued. Overall, ESG rating systems tend to reward companies with more information. It is possible for companies with historically weak ESG practices and solid reporting to score in line with or higher than their competitors while still realizing a higher ESG risk. Furthermore, evaluation methodologies based solely on disclosure allow companies to manipulate the process. Self-reported, non-certified sustainability reports tend to show companies in the best light and can draw less attention to material risks. According to the Sustainable Accounting Standards Board (SASB), 90% of negative events are not disclosed (Labella, Sullivan, Russell, & Novikov, 2019).

ESG ratings and rating agencies are not regulated. ESG ratings somewhat resemble credit ratings. However, the differences are notable, perhaps none as much as the fact that ESG ratings are more difficult to verify. The evaluator has room to express their subjective opinions. Such subjectivity and opacity are a hotbed of conflict of interest (Mehran & Stulz, 2007) which results in different outcomes.

Numerous studies find companies with high ESG ratings despite being involved in more or less major scandals (Chatterji et al., 2016). Facebook, Volkswagen, and Wirecard annex received good ratings from major ESG raters before their negative ESG incidents were uncovered. Moreover, the fact that Volkswagen was announced industry leader in the DJSI minutes before the scandal came out, also does not help the case (Tang, Yan, & Yao, 2021).

In addition to the aforementioned divergences, there are some distortions that affect the data of all rating agencies such as the size and geographic area of the company. Many companies have started documenting their sustainability policies. Larger companies have an advantage in this as they usually have greater transparency and resources to devote to such initiatives. Furthermore, the regulatory regulations of the various countries are different. Therefore, two companies in the same sector with similar characteristics but different jurisdictions can receive different evaluations because they are linked to different authorizations (Labella et al., 2019). Therefore, the information is either incomparable or investors do not know how to interpret it (Searcy & Buslovich, 2014) making its usability in investment strategies and stock selection, at best, limited (Dimson, Marsh, & Staunton, 2020).

This uncertainty and discrepancy in results should translate into caution on the part of users of ESG ratings. Drawing conclusions based on these results provided by a single ESG rating company could be misleading and lead to investing in companies that are only "subjectively" sustainable (Sylos Labini, Kostyuk, & Govorun, 2020; Labella et al., 2019; Rzeźnik et al., 2021). A system that does not validly and reliably reflect the reality of the various companies could have important effects, especially on investors who could be misled by unreliable results. This would nullify the contribution of SRIs to sustainable development (Esposito De Falco, Alvino, & Kostyuk, 2019; Hundal, Kostyuk, & Govorun, 2021; Busch, Bauer, & Orlitzky, 2016).

ESG investors need to be guided by true ESG performance which is currently a latent variable. This topic is haunted by a lack of standards, a lack of training, and a lack of consensus.

Despite the growing role of ESG ratings in capital markets, little research has been done on the ESG rating industry. This is worrying given the number of reasons why the sector should be regulated (Tang et al., 2022).

As things stand, very few studies have attempted to solve the problem and to our knowledge, no study has proposed a unique ESG rating. More research is needed to uncover important findings in practice and push for a unique rating that can help overcome current divergences.

This issue of the journal *Corporate Ownership and Control* is a truly multi-disciplinary issue with the studies considering various issues of corporate governance and many countries worldwide.

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