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Ratings divergence complicates anti-greenwashing measures

The risks associated with greenwashing – false/misleading marketing regarding the sustainability attributes of a product or service – are on the rise with signs that net-zero and other commitments made by some members of the financial sector may not be credible. But identification of greenwashing practices remains problematic as the limitations of agencies charged with evaluating ESG practices become apparent.

Investors and other market players are becoming more astute at sniffing out greenwashing, increasing the pressure on financial institutions and other businesses to conform. Meanwhile, regulators are scrambling to produce more rules, standards, and guidance to help businesses understand and comply with their responsibilities when making sustainability claims. These forces might seem to spell the beginning of the end for greenwashing – the presentation of investment products or commercial activities in such a way as to depict them as being more environmentally friendly or sustainable than they really are.

Difficulties with defining greenwashing

For asset managers, the ESG imperative is increasing. In many cases an investment product's sustainable credentials, as indicated by product labelling, has major commerical implications. Consequently, vigilance around greenwashing has increased. But one of the difficulties of defining and identifying greenwashing is the fact that definitions of "green" and "sustainable" differ. This is compounded by the difficulty in sourcing independent, verifiable, and comparable data around ESG performance.

To that end, more and more financial institutions rely on ESG ratings to obtain a third-party assessment of corporations' ESG performance. To the extent that such ESG ratings are positive, so those companies will benefit from investor demand, and vice-versa.

Inconsistency in ESG ratings

However, research by the MIT and the University of Zürich showed that ESG ratings from different providers “disagree substantially.” It showed that correlations between six different ratings agencies range from 0.38 to 0.71. According to the authors this makes it difficult to evaluate the ESG performance of companies, funds, and portfolios, which is the primary purpose of ESG ratings. The research also concluded that this divergence had a number of secondary effects.

Lack of consistency decreases companies’ incentives to improve their ESG performance. In the event that companies receive mixed signals from ratings agencies about which actions concerning ESG are expected and will be valued by the market, the outcome may well be underinvestment in ESG improvement activities ex ante.

Ratings divergence also means that markets are less likely to price firms’ ESG performance ex post as the divergence of ratings disperses the effect of ESG performance on asset prices.

There are further implications for CEO compensation: “CEOs may optimize for one particular rating while underperforming in other important ESG issues—that is, CEOs might hit the target set by the rating but miss the point of improving the firm’s ESG performance more broadly.”

Finally, divergence in ratings can compromise empirical research depending on the choice of rater made.

Divergences in ESG ratings methodology

It is informative to isolate the sources of divergence identified by this research as it indicates the immense challenges involved in arriving at a consensus around ESG.

Scope divergence refers to the situation where ratings are based on different sets of attributes. One rating agency may include lobbying activities, while another might not, causing the two ratings to diverge.

Measurement divergence refers to a situation where rating agencies measure the same attribute using different indicators. As an example, a firm's labor practices could be evaluated on the basis of workforce turnover or by the number of labor-related court cases taken against the firm.

Finally, **weight divergence** emerges when ratings agencies take different views on the relative importance of attributes.

Because the contributions of scope, measurement, and weight divergence are intertwined, this makes it difficult to interpret the difference between two ESG ratings.

With divergences between ratings agencies being routine, calls have been made for a wider evaluation of ESG credentials. In the case of mutual funds, for instance, the credibility of their ESG claims are increasingly being tested not just in relation to their sustainability scores, but also on their commitment to ESG investment as indicated by their voting record.

Greenwashing appears to be overstated

On this basis, academic research has concluded that one-in-four funds that claim to invest according to ESG considerations fail to honor this promise to their investors. The research also noted that greenwashers are more frequently found in larger and older fund families. While asset management companies that have signed the UNPRI (UN Principles for Responsible Investing) pledge do not seem to invest more according to those principles than non-signatories, they are less likely to offer funds that falsely claim to be ESG.

This report concludes that its results "suggest that accusations of ubiquitous greenwashing by asset management companies overstate the true extent of the problem." Nonetheless, the report also notes that retail investors rely strongly on ratings but do not seem to take funds' voting records into account when evaluating funds' commitment to ESG investing. On the other hand, institutional investors seem to be able to distinguish between greenwashers and true ESG funds. On that basis, the research suggests, there is more room for regulation aimed at enhanced ESG disclosure "at least for those funds targeted at retail investors".

Intuition *Know-How* has a number of tutorials relevant to the topics covered by this article:

- ESG – Primer
- ESG – An Introduction
- ESG Factors
- ESG Reporting
- ESG Data & Ratings – An Introduction
- ESG Data & Ratings – Reporting Frameworks
- Sustainable & Responsible Investing – An Introduction
- Sustainable & Responsible Investing – Strategies
- Impact Investing

"*Trustworthy*" AI – Can regulation enhance trust in the AI that businesses and people are using?

As part of its "Coordinated Plan on Artificial Intelligence," the EU has proposed a regulation that sets out harmonized rules on artificial intelligence. This addresses "the risks and problems linked to AI, without unduly constraining or hindering technological development or otherwise disproportionately increasing the cost of placing AI solutions on the market." Many other countries are also looking at introducing legal frameworks around the use of AI. Why are such regulations emerging and will they improve or hinder the uptake of AI?

The EU Plan looks to "act and align to seize opportunities of AI technologies and to facilitate the European approach to AI, that is human-centric, trustworthy, secure, sustainable and inclusive AI, in full respect of our core European values." In doing so, it sets out four key sets of proposals:

1. Set enabling conditions for AI development and uptake in the EU
2. Make the EU the place where excellence thrives from the lab to the market
3. Ensure that AI works for people and is a force for good in society
4. Build strategic leadership in high-impact sectors

In pursuit of the third objective, the issue of trust has emerged as critical. This forms a central part of the Plan and sets out the overall intention and the measures implemented to date to develop a policy framework to ensure trust in AI systems. This requires a framework that seeks to ensure the protection of EU values and fundamental rights such as non-discrimination, privacy and data protection, and the sustainable and efficient use of resources.

OECD AI principles looks for human-centric approach

But while the EU is looking to promote its "vision on sustainable and trustworthy AI" and many other similar national and supranational initiatives are already under way, the extent to which government and regulation can ensure the promotion of trust in AI is open to debate. The OECD AI Principles set out "a common aspiration" for its adhering countries and focuses on "how governments and other actors can shape a human-centric approach to trustworthy AI."

Following on from the Principles, the OECD Recommendations on Artificial Intelligence identify “five complementary values-based principles for the responsible stewardship of trustworthy AI and calls on AI actors to promote and implement them.”

- **Inclusive growth, sustainable development, and well-being** guides the development and use of AI toward prosperity and beneficial outcomes for people and the planet as a priority.
- **Human-centered values and fairness** governs the view that AI systems should be designed in a way that respects the rule of law, human rights, democratic values, and diversity, and should include appropriate safeguards to ensure a fair and just society.
- **Transparency and explainability** promotes transparency and responsible disclosure around AI systems to ensure that people understand when they are engaging with them and can challenge outcomes.
- **Robustness, security, and safety** means that AI systems must function in a robust, secure, and safe way throughout their lifetimes, and potential risks should be continually assessed and managed.
- **Accountability** believes that AI actors should be accountable for the proper functioning of AI systems and for the respect of the above principles, based on their roles, the context, and consistent with the state of art.

Government intervention in AI a prerequisite for trust

On the face of things, the OECD principles seem admirable and desirable, and the capacity for bad actors to harness AI for mischievous or nefarious ends is gradually dawning on public consciousness. Meanwhile, the reaction to the release of ChatGPT has demonstrated the capacity of AI to revolutionize day-to-day activities until recently considered outside the capabilities of machines.

Certain governing regimes may take issue with aspects of one or more of the OECD principles but the actual and potential power of AI is such that massive government intervention in AI development can be expected, as evidenced by the OECD’s recommendations for policymakers, and would appear to be a prerequisite to secure public trust in AI systems.

Intuition *Know-How* has a number of tutorials relevant to AI and the associated issues:

- Information Technology (IT) in Business
- FinTech – An Introduction
- AI Ethics – An Introduction
- AI Ethics – Key Principles
- AI Ethics – Key Issues
- AI Ethics – Bias & Discrimination
- AI Ethics – Data Privacy & Security

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