Using ESG ratings: Motivations, benchmarking, and performance

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Abstract

Blind trust in composite ESG ratings can lead to biased managerial and/or investment decisions that severely impact social, environmental, and financial performance. We illustrate this bias in two separate settings: an environmental- and a risk management setting. Our findings reveal that existing ESG ratings do not adequately distinguish between display of commitment to environmental management and actual pollution levels. We propose a commitment and a pollution's measure and show that only the pollution measure can predict the chance of receiving an environmental fine. In the risk management setting, where composite social scores have been used to capture social capital, we build a stakeholder loyalty score. We demonstrate that stakeholder loyalty better captures the notion of social capital through firms observing lower probabilities of default.

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