The Market for ESG Ratings

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Overview

- Why I liked this paper:
  - Blend of information acquisition with information pricing.
- Where I struggled:
  - Puzzle with ESG in particular.
- What's coming:
  - Brief Summary.
  - Two comments.

Setup

- Three periods.
- Investor (solely) cares about one N-dimensional risk.
- Performance in each dimension can be L or H with prob η.
- Investor decides whether to invest I, and is *very* risk-averse. For two-dimensional:

$$\eta \times u(HH) + (1 - \eta) \times u(HL) < 0$$

Information

- N raters give binary ratings either accurate or uninformative $P(s_{ij} = H | j = H) = \lambda_{ij}$.
  - No type I (or type II?) errors.
- Capacity constraint on lambdas $\sum_j \lambda_{ij} < \bar{\lambda}_i$.
- Randomly determined order of pricing/offering.

Optimality

- Social value highest for specialized ratings (least redundancy).
- But ratings assumed to be complementary (second H much more valuable than first).
- Sum of marginal benefit of specialized ratings higher than combined value.
- Individual specialization is rarely an equilibrium (specialized raters can't get paid).

Results in Context

- Specialization is a natural phenomenon.
- Occurs in the NRE literature, has been used to explain:
  - Home-bias puzzle.
  - Contagion.
  - Wealth/Income Inequality.
- Actually kind of hard to get generalization. Need something like:
  - Market power.
  - Systemic shocks.
  - (in this case) Flexible V

Comment 1: Positive or Normative?

- Motivation is that analysts' forecasts are not correlated.
- Claim is that they could be specializing.
- Which is already first best?
- So why bother with generalization equilibria if they're not doing it?
- Does this show that ratings are not complements?

Comment 1: Positive or Normative?

- Positive framing: ESG analysts specialize. Need model to understand why.
  - Pros: Clear path from empirical fact to model.
  - Cons: Explaining specialization is easy.
- Normative framing: ESG analysts specialize. Is specialization socially optimal?
  - Pros: First order question, with room in the model to explore lots of options.
  - Cons: Hard to establish welfare criterion.

Comment 2: Why ESG?

- Multidimensional risk summarized by one variable.
- V and Leontief preferences.
- Why not analyst reports?
  - Price has many inputs (dividends/earnings/sentiment/etc).
  - Summarized by one variable (forecasted price).
  - Tends towards generalization over specialization - potential puzzle!
  - Easier to come up with a justifiable V.

Other Comments: For Authors

- Not sure your paper can talk about 'measurement divergence'. If a rating is returned in a category, it is correct.
- A high number of relatively unusual assumptions. Harder to see how robust the mechanism is. Consider relaxing:
  - Binary performance/signals.
  - Allowing for false positives and false negatives simultaneously.
  - More structure around V/why ESG matters for investing.
- Need some empirical motivation for sequential pricing.
- What is the marginal benefit of a rating? If they're offered sequentially, could they not be purchased sequentially as well?
- Intro talks about welfare/social planner, but I see nothing on this later in the paper. What is the welfare criterion? V?

State of Play

- Very interesting model with a lot of room (paper is scratching the surface).
- Could use more clarity around positive/normative framing.
- Link to ESG is present, but possibly not optimal.