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American Heartland Can Tell Us a Lot About What's Wrong With ESG

(Bloomberg) -- What is Fifth Third Bancorp? By most accounts, it's a regional bank based in Cincinnati. Descended from the Bank of the Ohio Valley founded in 1858 to service an influx of western-bound settlers and then merged with a succession of local lenders in subsequent decades, the company has grown to become the quintessential mid-sized bank for Middle America.

Its history has often mirrored that of its founding state, with Fifth Third helping to fund the growth of what historian Steven J. Ross has called the "first great industrial metropolis of the Midwest." Nowadays the company is a reliable lender and issuer in capital markets. Credit rating agencies Standard & Poor's and Moody's grade its bonds as 'BBB+' and 'Baa1' respectively, firmly in 'lower medium' investment-grade territory.

But in another way, Fifth Third is very controversial. In the world of ESG ratings no one can agree on quite where the bank stands, exactly. Fifth Third's Global ESG Rank from Standard & Poor's comes in at 49 — handily beating industry averages on all three ESG metrics. At rival ESG ratings firm MSCI, however, the bank receives a paltry 'B' rating — well below average for its peer group and making it a laggard among 190 other banking companies. Using a simple translation framework, S&P's ESG ranking works out to something like a 'BBB,' far above where MSCI rates the same company.

In this way, Middle America's mid-sized bank is emblematic of a wider problem now plaguing one of the hottest corners of finance: No one can quite agree on where companies stand when it comes to the trifecta of ESG concerns — environmental, social and governance — that has morphed into a responsible investing craze worth trillions of dollars. In fact, a quick tour through Ohio — once a major Midwestern manufacturing capital before falling into 'Rust Belt' status in the 1980s as factories shifted abroad — can give us a peek into the failure of socially-responsible capitalism to so far actually improve society.What Is ESG Anyway? Say what you will about regular credit ratings, but they are remarkably consistent. The major agencies — S&P, Moody's and Fitch — are rarely out of sync in the way that ESG arbiters have so far tended to be. While there might be some variation at key turning points in a company's trajectory (and one could argue that their pay-to-play model goes some way towards encouraging accord), it's unusual to see major credit rating agencies disagree by multiple notches in a meaningful way. Yet study after study has shown that ESG ratings on offer from the new ESG assessment industry (which, in the interests of disclosure, includes Bloomberg LP) vary wildly. Here, disagreement is the norm rather than the exception. New research from JPMorgan Chase & Co., for instance, shows that while S&P and Moody's agree with each other more than 75% of the time on the alphabet soup of AAAs, AAs, As and BBBs that go into evaluating a company's creditworthiness, only about 17% of ESG designations from MSCI and S&P match up in the same way

As with Fifth Third, there are a number of companies in which the two ESG raters aren't in agreement at all. When it comes to Nissan Motor Co., for instance, S&P gives the carmaker an ESG score of 61, which roughly translates to an 'A' in MSCI's methodology. MSCI, meanwhile, grades it multiple notches lower at 'CCC.'

"Arguably, some of these differences have good reasons behind them, while others seem somewhat more random and likely stem from inconsistent and incoherent data feeding these ratings," say JPMorgan fixed income analysts led by Alex Roever.

"Until the market agrees on a uniform set of consistent disclosures," they add, "it is hard to see how ESG ratings can become more objective." In many ways, the unbearable unlikeness of ESG ratings is probably the nascent industry's least worrying problem, with many describing such divergences as mere growing pains as participants strive to standardize disclosures and formalize criteria around subjective concepts such as 'social fairness.'

But even if rating agencies could agree where Fifth Third ranks in terms of its ESG qualifications, it's unclear what the ultimate goal of a reliable ESG framework would be for investors armed with this information. Should they shun the company in favor of other banks — or industries — that score better? Or should investors engage with lower-scoring companies to try to encourage them to improve their ESG metrics? What's the Goal of ESG?

One the other side of Ohio, miles from Fifth Third's Cincinnati offices, are the Northeast oil and gas wells of Louisiana-based Hilcorp Energy Co. While not publicly-listed, Hilcorp does issue bonds to help fund its oil and gas exploration across the United States, working with a laundry list of bank bookrunners — including Fifth Third.

Hilcorp has built a reputation for zigging when the rest of the energy market zags. Most notably, in recent times it's been busy scooping up assets offloaded by larger oil majors who are under pressure to divest their dirtiest, most polluting properties in order to meet climate targets. That's sparked criticism that while conscientious investing may force a company like BP Plc to divest problematic oil fields, it does nothing to actually prevent those same fields from spewing carbon into the air.

Much of ESG operates on the principle that socially-responsible companies should be rewarded with lots of dollar inflows from socially conscious investors that will eventually translate into lower capital costs. There's some evidence that's been happening, with data released by S&P Global Ratings back in June showing bond investors finally appeared to be 'punishing' more polluting energy firms with higher funding costs. But since ESG investment plays out across a multitude of pools of capital of differing sizes and behavior, the results of these incentives can be inconsistent and difficult to predict. Back in 2019, for instance, analysts at Citigroup Inc. argued that funding costs for European energy majors — many of which have mounted wide-ranging plans and targets to combat climate change — were an average 200 basis points more expensive than their U.S. counterparts.The divergence emerged not because American energy companies were doing better at ESG, but because European investors tended to care more about sustainability on the whole, to the detriment of regional energy companies — irrespective of their ESG performance. In other words, European investors were shunning the sector entirely as opposed to funding the best actors within it. The concern is that ESG is ultimately creating two different playbooks — one for companies under scrutiny from large investors and another for those corporate actors who can pick up stranded assets on the cheap and use them to make profits without quite the same ethical burden being imposed upon them. "No matter how much you or I might abhor companies that pollute the planet, gouge the sick with criminally high pharmaceutical prices, produce dangerous weapons for public purchase, or poison our democracy with dangerous conspiracy theories, we can't make the shares of those companies disappear; someone will own them," argues William Bernstein, co-founder of Efficient Frontier Advisors.What's the Impact of ESG? Cleveland in 1919 bore witness to a violent clash as socialists marching from the party's headquarters at Germania Hall encountered a group of soldiers and veterans who took offense at their red flags and provocative labor rights slogans. Now, just a couple blocks from the former socialist headquarters, sits one of the most potent symbols of American capitalism: a McDonald's sited on an avenue named after industrialist Andrew Carnegie. For Vincent Deluard, former director of global macro at INTL FCStone Inc. and now at StoneX Group Inc., the fast-food chain's iconic golden arches are representative of another major weakness in ESG investing: a hidden tendency for ESG investors to herd into companies that pay the least taxes and employ the fewest people. Encouraging more money to flow into tech, healthcare and financials, he argues, is hardly the result that Rust Belt states like Ohio might desire. "ESG's bias against employees is like the subconscious mammary theme in McDonald's yellow arches: once you see it, it is impossible to see anything else," Deluard wrote in research published earlier this year.

"ESG's bias against humans is probably unconscious, but it is a feature, rather than a bug. Companies with no employees do not have strikes or problems with their unions," Deluard explains. "There is no gender pay gap when production is completed by robots and algorithms. Biotech labs where a handful of PhDs strive to find the next blockbuster molecule have no carbon footprint. Financial networks which enjoy a natural monopoly in processing payments can have the luxury of ticking all the boxes of the corporate governance check list." He's not the only one to have argued that ESG funds are essentially big bets on growth companies in disguise. Bloomberg data shows tech stocks accounting for more than 31% in the five largest ESG exchange-traded funds, compared with less than 29% in the S&P 500 (though the figure is growing). In Ohio, where the historic loss of manufacturing jobs to automation has in recent years been complemented by one of the worst opioid-related overdose rates in the U.S., there's a supreme irony to the notion that 'doing good' may involve shifting more money into big tech and big pharma.

Such an investment framework may encourage a relatively low carbon footprint, but it's probably not be doing much in terms of creating job opportunities, helping to alleviate wealth inequality or maintaining the social fabric of the state. ESG's allure is predicated on the idea of using capitalism to solve some of the world's most intractable problems. But the inconsistent way in which ESG principles are applied — through mismatched ratings that create perverse incentives and herd investors into profitable but controversial industries — has arguably so far done little to improve American lives. "ESG became popular as a private sector-led approach to decarbonizing finance," says Daniela Gabor, a professor of Economics and Macro-Finance at UWE Bristol. "But several years in, we know, and regulators admit, that ESG is ridden with conflicts of interests, and prone to systemic greenwashing. If regulators are serious about decarbonization, they cannot leave green/dirty taxonomies to the market." In Ohio, ESG means no one's quite sure whether one of the state's biggest banks is an outperformer or a laggard when it comes to social and environmental responsibility. It means the most polluting of energy assets are abandoned by one company trying to clean up its act, only to be snapped up by another. And it means companies which employ the fewest and pay the least in taxes often tend to be singled out for the most inflows from ostensibly socially-minded investors. In America's Heartland, ESG investing does little to alleviate the fundamental tension between individual freedom and collective responsibility.