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EBF input to the Commission's discussion paper for the workshop on sustainability research and ratings

The European Banking Federation is the voice of the European banking sector, uniting **32 national banking associations** in Europe that together represent some **3,500 banks** – large and small, wholesale and retail, local and international – employing about **two million people**.

Section 1: Offer of sustainability ratings and research

Q1. What are the main categories of ESG performance tools and what does each seek to assess or measure?

- ESG ratings – focusing on policies, programs and performance
- Alert service
- Controversy and/or product involvement screening
- Global compact compliance

More recent categories:

- SDG alignment screening
- Foot printing data – particularly water, waste and carbon
- 2degree alignment screening

Comments:

- ESG Rating agencies group sets of varying questions around the three themes Environment (E), Social (S) and Governance (G). There is no uniform definition of what an ESG-rating signifies, and it cannot be compared with a credit rating where the ultimate aim is to provide opinion on the likelihood of timely payment within a range of definitions (regulatory intervention; first dollar default; ultimate loss for investor).

- The main tools used to make these assessments are those that can be easily retrieved and are publicly available. ESG rating agencies do not always enter into dialogue with the companies they rate which sometimes results in factually incorrect analyses and misleading/incorrect conclusions.
- Based on available documentation, an ESG rating is in practise just a list of checks where the availability of certain documentation is seen as proof of real results. As integrated reporting standards such as TCFD become more prevalent, the foundation may be laid for more proper analytical work.

- ESG ratings combine a set of factors that may be wholly or partially unrelated and sometimes offsetting. The resulting ratings issued by ESG Ratings agencies tend to differ. A company may be considered very high risk, medium risk and low risk at the same time when rated by three different agencies.

Q2. Which methodologies and sources of information are used?

- It is difficult to understand the methodology behind a specific ESG rating as ESG rating providers consider the methodologies proprietary information.

- All ESG rating agencies rely on publicly available information. Some maintain a policy that only public information can be included in the analysis, while others accept and include non-public information.

- Information used is mostly based on

    - company reports/data,
    - footprinting data (comes partly from company reports but is also often checked by the provider and if the data is not available it is estimated by the provider)
    - and information for alert services comes from media, NGO's and many other information sources.

- Given the reliance on the public information, the practice of increased disclosure is often given more value by the agencies than the underlying risk the disclosures address.

- It is important that methodologies and information sourcing are capable of considering relevant national conditions. This can for instance be special mortgage systems, collective agreements on the labour market, welfare benefits etc that can have positive impact on ESG rating. For instance, a mortgage system that provides loans to people from all social classes and makes it possible for most people to own their own home should score well on the social dimension in ESG-ratings.

Q3. How is quality assured?

- Information like reporting often comes with a reliability score. We have no insight as to whether third party review ore any oversight is applied.

- It is however evident from systematic peer analysis that ESG ratings are produced by organisations that are understaffed relative to the complexity of the analytical tasks. Analysts covers hundreds of companies and do not have capacity to dedicate to in-depth analysis of the company. They generally assign E, S and G weights to companies without factoring in company specific risks.

- Investors have often been critical of the ability of agencies to identify and evaluate the risk. Specifically, in relation to banks, there is a knowledge shortfall also in relation to knowledge about law, regulation and basic banking principles.

- In this context, we would like to mention the initiative of the World Benchmarking Alliance https://www.worldbenchmarkingalliance.org/. The Alliance is an initiative partly organised by the Dutch Government to create an open platform and to make the results of different rating agencies public, therefore creating more impact.

Q4. What is the level of transparency and type of disclosure as to the methodologies, sources of information, quality reviews?

- See response to question 2. In addition, ESG rating agencies rely on media and internet to scan for information, in particular in relation to controversies. Such data is generally indicated in the reports under a specific heading. Given the fiduciary duty of investors, the usefulness of such information is questionable. There are typically public statements that indicate great commitment to quality standards, integrity and high ethical standards; however, these are not clearly substantiated.

Q5. Who is paying for sustainability ratings and research?

- In principle investors pay for ESG ratings. Ratings are assigned without the consent of the issuer but are sometimes initiated on the specific request of an investor (iMug). However, there are example of rating agencies that may accept non-public information for a fee.

Q6. Are SMEs covered by the existing sustainability market research and ratings?

- For listed Small and Mid cap companies this data is becoming increasingly available, but the focus lies on the Large caps. Some providers are more specialized in SME companies but in general these are insufficiently covered. SME's will most often not have the resources to participate.

Q7. Are all geographical areas and economic sectors covered by the existing sustainability market research and ratings?

- The focus lies on developed markets.

Q8. Has the entry into force of MiFID II changed the way sustainability research is produced? Not for us, as the brokers we use are different from the sustainability research providers.

- There is no real change post MiFID II. ESG ratings are still relatively new as a capital markets phenomenon and is still in a comparatively early development phase.

Section 2 : Use of sustainability ratings and research

Q1. Which ESG performance tools are mostly used for investment decision making?

- Most often global compact screening. This seems to be the most basic screening applied by most investors.

- Various ESG performance tools is used, including a range of ESG ratings, from different rating agencies and data providers, including e.g., Arabesque, Bloomberg ESG, CDP, Imug, ISS, ISS-ESG, MSCI ESG Research, RepRisk, RobecoSAM, Sustainalytics, TruCost, TruValueLab, Sigwatch2, and Vigeo Eiris (acquired by Moody's.

- All agencies also use a set of different criteria, thresholds, boundaries, as well as reference to frameworks and initiatives such as e.g. the UN SDGs, UN Global Compact, PRI, etc.

Q2. Do ESG performance tools provide reliable and comparable results?

- The focus of data providers is still on exclusions and relative ESG performance. More focus and data on positive impact would be welcome. While indeed some asset managers or investors may find merits in the diversity of ratings, research or analysis, it seems that most find it confusing to get very diverging ratings from different providers on the same company or product. The lack of comparability is due to the lack of uniformity of the rating scales, criteria and objectives as well as lack of standardized disclosures. There is also lack of auditable information to analyse and compare.

Q3. What are the obstacles for further improvements of quality and accuracy of sustainability ratings and research?

- Availability and reliability of data and lack of standard/harmonized definition and approach. This means that the data that is available is also difficult to compare. Harmonization and more transparency of the methodologies used by the rating providers would be appreciated. While technical algorithms and proprietary information does not have to be disclosed, it would be useful to understand what material information rating providers are looking at and how this is being used.

Section 3: Relations between providers of sustainability tools and assessed entities

Q1. Do ESG performance tools providers have connections with rated entities?

- Several providers have links with rated entities such as in case of financial institutions that are both rated entities and receivers of the services.

Q2. Which difficulties do companies encounter in responding to the request for data/information by ESG performance tools providers?

- As there is no clear definition and providers want to be unique companies are faced with many different questions. This leads to thick ESG or integrated reports. We would prefer to see focus in companies reporting on the most material data. Issuers lack clarity to understand the assessment criteria which also means it is difficult for them to improve their rating.

- ESG rating agencies typically provide a draft report for the customer to comment on. After an arbitrary time-period, the rating agency then publishes its report whether or not it has been given feedback. There is typically no sharing of the final report prior to publication as in the case for credit ratings. This means that it is not possible for the rated entity to assess prior to publication if information provided has been take into account or not.

- In one case (Vigeo Eiris) the rated entity is not allowed to know the resulting rating. In other cases certain information is disseminated without informing the rated entity (Sustainalytics)

- In general, information is not disclosed to the public but provided to subscribers only, again in contrast to rating agencies where ratings are disseminated publicly for all market participants to consider. This produces situations where market prices may be manipulated.

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