11 March 2022

# EBF RESPONSE: ESMA CALL FOR EVIDENCE ON MARKET CHARACTERISTICS FOR ESG RATING PROVIDERS IN THE EU

## Part B

### 6.2.2 Use of ESG Ratings

**Q8 Please outline and explain any shortcomings in the ESG rating or ESG data products** ~~you currently contract for.~~

Most users have difficulty understanding **the methodology behind a specific ESG rating as ESG rating providers consider the methodologies proprietary information** and most of them providelimited transparency about the methodologies and the rating process.

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 an 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 the assessments are those that can be easily retrieved and are publicly available. The 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. In some cases use of outdated data has been highlighted by clients in the past.

ESG ratings therefore combine a set of factors that may be wholly or partially unrelated and sometimes offsetting. As a result of the little coherence in methodologies across ESG rating providers, we see different weights of factors which can heavily influence the overall results and create diverging outcomes[1], implicitly offering different views on the same data and events with extraordinary low correlations for governance. **A company may be considered very high risk, medium risk and low risk at the same time when rated by three different agencies**. Given the reliance on public information, the practice of increased disclosure is often given more value by the agencies than the underlying risk the disclosures address. The ratings sometimes result in factually incorrect analyses and misleading/incorrect conclusions, which might also be caused by the fact that ESG ratings are often automated and can include limited human analysis, which could be useful in the case of complex industry evaluations.

Some ratings are absolute and others are relative (in peer review comparison) - this also limits the comparability of ratings.

1 The Journal of Portfolio Management, 2021 Divergent ESG Rating: Elroy Dimson, Paul Marsh, Mike Staunton

**European Banking Federation aisbl**

**Brussels /** Avenue des Arts 56, 1000 Brussels, Belgium / +32 2 508 3711 / info@ebf.eu

**Frankfurt /** Weißfrauenstraße 12-16, 60311 Frankfurt, Germany

**EU Transparency Register /** ID number: 4722660838-23

In addition, **ESG rating agencies enter into dialogue with the companies they rate, but at times are not responsive to the users request for clarification (even if they assess companies based on their responsiveness)**. Some maintain a policy that only public information can be included in the analysis, while others accept and include non-public information. Those, who enter into dialogue, 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, without specifying whether the assessed company provided any feedback or not. A statement considering the integration of the feedback (integrated or not ) should be required by ESMA. 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 the information provided has been take into account or not.

Moreover, ESG ratings are often automated and can include limited human analysis which might be needed for example in complex industries.

Sometimes the rated entity is not allowed to know the resulting rating. In other cases, certain information is disseminated without informing the rated entity. 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.

Finally, there is **a risk of dependency upon a limited number of non-European providers**, and potential conflicts of interest.

**Q9: Please outline whether you are satisfied with the level of methodological transparency** ~~for the products you contract for, including transparency around data sourcing~~

**No. It is difficult to understand the methodology behind a specific ESG rating as ESG rating providers consider the methodologies proprietary information**. The lack of clarity also means that issuers do not fully understand the assessment criteria and it is therefore difficult for them to improve their rating. Some agencies fully rely on quantitative methods of reporting where different competences converge in a single outcome. Others still privilege the single analyst approach where a single professional works as collector and owner of the outcome.

**Availability and reliability of data and lack of standard/harmonized definitions and approaches is also an issue.** Even if the data is available, it is 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.

Information like reporting often comes with a **reliability** score. We have no insight as to whether third party review or any oversight is applied. It is however evident from systematic peer analyses that ESG ratings are produced by organisations that are understaffed with respect to the complexity of the analytical tasks. Analysts covers hundreds of companies and do not have the capacity to thoroughly analyze the company in depth. They generally assign E, S and G weights to companies without fully factoring in company specific risks. This sometimes results in factually incorrect analyses and misleading/incorrect conclusions.

Indeed, 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.

What we expect in terms of transparency:

o **Transparency around the source of ESG data (e.g., publicly disclosed, proxies/estimates, primary source of information regarding controversial events, or other proprietary data), and the frequency with which that data is updated)**

o **Transparency on product methodology in order for users to be able to determine quality and suitability of a product for their particular use case including on changes of methodologies. Transparency also when ESG data and rating providers change their methodologies**

o **Transparency on what a particular product is intended to measure (e.g., whether the product is measuring ESG risk or sustainability impact)**

The abovementioned problems exist with regard to ESG data products, which provide ESG scorings on specific investment products.

ESG data products are very important for credit institutions, institutional investors (Asset managers, insurance undertakings, pension funds) and for investment firms providing investment advice with a portfolio approach and portfolio management services. In fact, ESG scoring represents a synthetic quantitative measure which helps investment firms classify/rank investment products according to their sustainable characteristics.

But also, ESG data products are very fragmented, use different approaches and methodologies, which are not transparent. That's why institutional investors and investment firms often use more ESG data providers and filter/adjust their outcome in order to make them more reliable.

Users (including Asset managers, credit institutions or investment firms) therefore expect that ESG data products become more

- granular and coherent with regulations (for instance SFDR and MiFID II/IDD ESG requirements…)
- reliable
- accessible
- comparable
- updated
- usable.

In view of this it should also be clarified what the difference between ESG ratings and ESG data products at regulatory level is.

Would new measures be introduced on these ESG rating providers, the priority should be to provide more transparency to users on several aspects such as governance, handling of conflicts of interest, quality of data (e.g., how frequently it is updated), methodologies,

changes in methodologies, etc. **Adoption of good practice standards** could be relevant in this area as it would allow to reach a better level of transparency. In any case, such standards or rules should not undermine the current **diversity** offered by ESG rating providers. **Competitiveness** should be maintained, and stricter rules should not result in further concentration of these ESG rating providers.

### 6.2.4 General views on ESG ratings in EU Financial Markets

**Q1. Please provide your views on the level of relevance of ESG ratings to EU financial markets and financial market participants. Do you consider this level will increase in the coming years.**

The level of relevance of ESG ratings in EU financial markets is currently high, certainly relative to other developed country financial markets (e.g., US). As SFDR/MIFID regulations come into force, ESG ratings and related information will certainly grow in relevance as these regulations will serve to standardize and enhance existing financial institution and corporate disclosures on sustainability-related topics. As financial markets thrive on information, the availability of new and cleaner data from issuers will facilitate price discovery and could possibly mitigate systemic market risk.

While those ESG providers remain largely unregulated, their influence is expected to grow considerably. The rise of ESG's importance in investment decision-making has unsurprisingly presented a market opportunity for a growing number of players to emerge to service this need and ESG ratings can provide an aggregated view.

There are more than 600 ESG standards and frameworks, data providers, ratings and rankings, provided by a mix of established credit rating agencies and data vendors along with niche providers.

Challenges include discrepancies in ESG measurements and ongoing data quality problems.

In practice, we should avoid that ESG ratings are just a list of checks where the availability of certain documentation is seen as proof of real results. There are typically public statements that indicate great commitment to quality standards, integrity and high ethical standards; however, these are not clearly substantiated.

In addition, ESG rating agencies rely on media and the 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**, especially as it is not considered whether a past controversy is legally solved or not (sometimes to the advantage of accused as the controversy may have been based on rumours). While we understand that there are limited other sources to scan for controversies, but we would advocate that these issues should be more deeply investigated before deciding on a negative impact on ratings..

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. As market participants are used to and trust in credit ratings, they are looking for a similar approach when it comes to ESG.

**European Banking Federation aisbl**

**Brussels /** Avenue des Arts 56, 1000 Brussels, Belgium / +32 2 508 3711 / info@ebf.eu
**Frankfurt /** Weißfrauenstraße 12-16, 60311 Frankfurt, Germany
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There is also **lack of auditable information** to analyse and compare.

As **integrated reporting standards such as TCFD** become more prevalent, the foundation may be laid for more proper analytical work. It is also important that methodologies and information sourcing are capable of considering relevant national conditions. This can for example 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.

Finally, 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.**

The overwhelming number of norms and regulations that is directly impacting the financial system is pushing many operators to find short term remedies to their positioning towards the new legal requirements. Many actors in the financial field are requesting turnkey solutions that are often offered by ESG rating companies. Such solutions concern the possibility for the buyer to receive prefab lists of companies that are allegedly involved in specific activities or that are characterized by specific factors. It must be noted that a large amount of the data feeding the lists are estimates.

In addition, **the involvement of the entities subject to assessment should be reinforced**. **ESG rating providers should improve their information gathering processes with a dialogue with entities covered by their products. Companies should have a right of review before an ESG rating or data product is published.**

Finally, **the introduction of a clear framework with consistent global principles and harmonized standards for ESG rating** (EFRAG, IOSCO and International Sustainability Standards Board will help), currently lacking as mentioned above, would make it possible to have a clear and objective evaluation of financial market participants from ESG point of view with increasing use in the coming years.

**Q2. Please provide your views on the level of risk ESG ratings currently pose to orderly markets, financial stability and investor protection in the EU. Do you consider this level will increase in the coming years?**

Investors' interest in sustainable investments and engagement is booming and standardization, harmonization and transparency are needed to level the playing field amongst all participants.

ESG ratings will become even more important given the sustainability impetus and to support the implementation of regulatory requirements.

Due to the additional complexity linked to the high-level aggregation of ESG issues compared to credit ratings, it would be important to forsee the breakdown of the rating into three sub ratings, being E, S and G. Moreover, the impact that an organization has on the environment should also be taken into consideration by the rating: up until now, ESG ratings mainly focus on financial material ESG aspects and the gap between the expectation of investors and reality is widening ((i.e., oil and gas companies might be part of an ESG portfolio managed based on ESG ratings).

The possible inaccuracy of data and the last-minute changes of ratings, when unforeseen scandals occur for instance, might be perceived as a nuisance, yet it is hard to determine

if this poses any type of threat to market stability. Consequently, the assessment has to put on hold and reviewed based on a further evaluation of data/events.

### 6.3.3 General views on ESG ratings in EU Financial Markets

**Q1. Please provide your views on the level of relevance of ESG ratings to EU financial markets and financial market participants. Do you consider this level will increase in the coming years.**

Yes, and in the short-term it will further increase as the demand for more granular ESG data on individual companies will rise – with more sophisticated ways of integrating ESG into financial modelling.

**Q2. Please provide your views on the level of risk ESG ratings currently pose to orderly markets, financial stability and investor protection in the EU. Do you consider this level will increase in the coming years.**

Most ESG ratings focus on topics that are financially material only to a limited and varying extent. Hence, they only partly ensure the integration of ESG risks into investment and financing decisions. However, for financial market participants, who have just started integrating ESG into their risk management, this is supposedly an easy way of ticking the ESG box even though a more granular, thorough analysis of material topics for each individual company would be required. In addition, ESG ratings do not always take into account the impact and focus of an organization on the environment (double materiality) – hence there continues to be a gap between some investors' expectations (e.g. of retail investors) and real impact.

## About EBF

The European Banking Federation is the voice of the European banking sector, bringing together national banking associations from across Europe. The federation is committed to a thriving European economy that is underpinned by a stable, secure, and inclusive financial ecosystem, and to a flourishing society where financing is available to fund the dreams of citizens, businesses and innovators everywhere.

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For more information contact:

**Alexia Femia**
Sustainable Finance Policy Adviser

a.femia@ebf.eu

+32 473 13 1569