EBF comments to the European Commission proposal for a Regulation on ESG ratings

I. General comments

The EBF welcomes and supports the European Commission's proposal for a Regulation to enhance the transparency and integrity of ESG ratings. Given the growth of this market and the significant role played by ESG ratings in sustainable finance, it is important that issues highlighted by market players are addressed proactively.

The European Commission's proposal for a Regulation on the transparency and integrity of Environmental, Social and Governance (ESG) rating activities would significantly improve the current regulatory framework.

Here below we share our key considerations regarding the proposal at hand:

1. Transparency of methodologies

In order to ensure **a better degree of comparability, we suggest that a clear definition of what qualifies as an ESG rating** is included in the proposal. As the underlying methodologies of ESG rating providers may differ, it would be helpful that the proposal insists on transparency about the methodologies, data, results, and sub-results in the rating models. Indeed, it is currently challenging or not possible to understand the methodology underlying an ESG rating as ESG rating providers consider the methodologies proprietary information.

Transparency about data, analysis and methodology, including the use and weights of controversies in ESG ratings is needed. Such transparency would provide predictability and consistency between input and output from ESG rating providers, which are two key pieces of information that are currently lacking. Therefore, we welcome that the proposal gives the mandate to ESMA to develop draft regulatory technical standards to specify the detailed elements of "Disclosure of methodologies, models, key rating assumptions to the public" (Article 21) and "Disclosures to the subscribers of ESG ratings and to rated entities" (Article 22).

Further, we welcome the proposal to introduce a disclosure published on the ESG rating providers' websites of the methodologies they use in their rating activities, as well as information about the rated companies' fees, sources of the data and data "timestamps".

Finally, we believe it is crucial for ESG rating users to ascertain whether these ratings incorporate a forward-looking assessment of a company's sustainability. Notably, financial institutions, subject to Sustainable Finance Disclosure Regulation (SFDR), ESG in the Markets in Financial Instruments Directive (MiFID), Corporate Sustainability Reporting Directive (CSRD), and the EBA ESG Pillar 3 Framework (ESG Pillar 3), will increasingly require more granular ESG data from individual companies.

2. Feedback provisions

We would highly recommend the foreseeing that rated companies be involved in an **open dialogue with the rating provider to gather the necessary**

information to formulate the rating/score. As ESG ratings are often unsolicited, the rated entity is not always aware of the judgment issued or not involved in advance in an activity of information and dialogue with the ESG rating providers. For the rated entity, access to the information utilized to develop the rating should be made available free of charge allowing the possibility for the rated entity to address any potential misunderstandings. Once the rating has been issued, the rated company should be informed about the methodology used to develop each score contributing to the final rating.

The proposed approach described above secures three major objectives:

1. while the rated company has the right to be consulted in the data gathering of the rating provider in direct contact, it cannot unjustly influence the outcome of the rating, while it holds the right to react to the final rating either publicly or privately;

2. rating companies will be demanded to deeply scrutinize the information they gather and use to build a rating in line with traditional analytical processes;

3. users of ESG ratings would have a solid foundation for assessing a rating, while the rated entity gains an opportunity to comprehend the underlying rating methodology and the rationale behind a given rating. Consequently, the rated entity can then work towards transitioning into a sustainable business, thereby improving its rating.

Therefore, for the purpose of ensuring an effective interaction between ESG rating providers and covered entities, we suggest complementing the proposal accordingly (please see Article 16 bis under Section II below).

3. *Equivalence of regulatory rigorousness with existing CRA regulations*

We propose for the regulation of ESG ratings to be formulated as equivalently rigorous as the regulation of traditional credit rating activities. While the market and regulation of ESG ratings is not as developed as the market for credit ratings, it is now **with the establishment of a regulation that the framework for providers of ESG ratings must be set so that the ESG rating market can develop into a well-functioning and credible one**.

The quality of ESG ratings is generally challenged by the fact that the quality of the data used in ESG ratings is currently insufficient. This has a significant impact on the quality and credibility of ESG ratings, but this must not hinder the development of a regulatory framework for ESG ratings. As mentioned, the framework should be developed in the immediate term, and over time the data quality should progressively improve as the EU sustainability framework is developed further and integrated throughout the economy.

4. Scope of the regulation

We understand that the policy objective of the proposal is to address the gap in the regulatory perimeter for specialised providers of ESG ratings, rather than for products and services of regulated financial undertakings. We would suggest clarifying this within the proposed scope of the regulation **to ensure that it does not unintentionally capture market participants already subject to existing regulations.** While this proposal intends to capture non-regulated entities providing ESG ratings, financial undertakings are already subject to regulatory requirements. We would suggest clarifying that the regulation is directed solely towards ESG ratings providers in order to avoid duplicative regulatory requirements and potential conflicts between other financial services regulation and the future ESG ratings regulation**.**

Further, we have noticed the proposed exclusion of raw ESG data providers from the scope of the regulation. In this respect we would like to clarify that the exclusion can only be justified for raw ESG data, i.e., when the ESG data is merely collected directly from issuers and transmitted without any modification or analysis of such data. On the other hand, whenever the ESG data is modified in any manner or sourced from third parties (e.g. NGOs, press), the regulation of such activity is essential. Financial institutions rely on such information when conducting business, e.g., during the loan origination process. Regulating ESG data providers will increase the reliability of the information underlying important financial decisions while limiting the risk of financial institutions being unjustly accused of greenwashing. However, we understand that the current proposal was developed to cater to the specificities of ESG rating providers. In order to properly address the regulation of ESG data providers, we would suggest the introduction of a short-term review clause foreseeing the future inclusion of the requirements to which ESG data providers which modify raw ESG data in any manner would be subject to, following a thorough impact assessment. Specifically, we consider essential that the provisions consider the transparency of data sources, control of data quality and data coverage, disclosure of potential use of AI, and ensuring fair commercial practices.

5. Non-EU ESG rating providers

ESG ratings providers operating in the EU should be subject to the same requirements, regardless of whether they are based in the EU or not. Analogously, actors providing their benchmarks in the EU should adhere to the third country regime imposed by the 2Benchmark Regulation (please see Title II - Chapter 2 – "Third Country Regime" under Section II below).

6. *Proportionality*

We believe that proportionality as discussed in the proposal is considered only in relation to the ratings provider. **Proportionality in regard to the size and complexity of the rated entity may also merit being considered**. Unless addressed, there may be a disadvantage for non-multinationals and unlisted companies, including smaller financial institutions.

7. Independence and conflicts of interest

We believe **further accountability elements should be introduced** (i.e., other than supervision):

- ESG rating providers should be required to clearly disclose their level of independence and put in evidence the designated *Chinese walls* when needed.
  - Similar to credit ratings, it should also be clear when a rating has been solicited (paid for).
  - The ESG rating provider should also disclose which investors and shareholders are adopting a look-through approach to eliminate the possibility of favoritism.

(please see Title III - Chapter 3 under Section II below)

8. Organisational requirements, processes and documents concerning governance

We believe that the **separation of businesses and activities proposed by the regulation could pose a risk to the availability of certain other related services**, and should, for the purpose of facilitating the ESG rating market, be reconsidered. Further, we believe that the criteria defining ESG rating analysts should be further refined to specify characteristics that, among others, allow to relate ESG ratings to material financial risk to the rated entity.

9. ESMA supervision

Last but not least, **we welcome the proposal's suggestion that ESG rating providers be supervised by ESMA**, which will also be tasked with authorising providers of ESG ratings. We support this approach, as it is an essential prerequisite for investors and businesses to be able to rely on credible ESG ratings and make well-informed decisions and thus support the sustainable transformation of society.

II. Detailed comments on the proposal

TITLE II: PROVISION OF ESG RATINGS IN THE UNION

CHAPTER 2: Provision of ESG ratings in the Union by third country ESG rating providers

Non-EU ESG rating providers operating in Europe should apply the EU regulation

In the proposal under consultation, ESG rating providers based outside the EU that are already subject to foreign regulatory oversight do not have to provide additional transparency. This would allow providers such as MSCI, Sustainalytics and ISS to continue their current businesses without being affected by the regulation. However, we believe that **a level playing field for ESG rating providers operating in the EU should be ensured by subjecting them to the same requirements, regardless of whether they are based in the EU or not**. Again, the requirements for ESG ratings and ESG rating providers should be the same as for credit rating providers, where, among other things, a presence in the EU is required to operate in the market.

Third Country Regime

Furthermore, we are concerned with the Commission's intended use of the Benchmark Regulations existing third country regime to allow third country rating providers to offer their ratings in the EU (through either equivalence, recognition or endorsement). Considering that many banks use ESG ratings produced by non-EU rating providers, the proper functioning of this third country regime is vital.

Currently, the Benchmark Regulation provides a transition period until the end of 2023, which allows third country benchmark providers to continue providing their benchmarks in the EU without adhering to this regime. It is expected that the Commission will extend said transition period to the end of 2025 in the near future. Post-Brexit, the UK also inherited this third country regime, has already extended it until end-2025 and will likely overhaul the system before the end of the transition period. The ESG Ratings Regulation should thus only reference a new and revised third country regime from the Benchmark Regulation

TITLE III: INTEGRITY AND RELIABILITY OF ESG RATING ACTIVITIES

CHAPTER 1: Organisational requirements, processes and documents concerning governance

Article 14 (General Principles)

Intellectual Property (IP) rights: Article 14(12) mentions restrictions on, among other things, ESG rating providers' disclosure of IP rights. Such possibilities do not exist in the regulation of credit ratings, and here too we find it is important to have symmetric rules so that full transparency about the methods and data of ESG rating providers is achieved.

Article 15 (Separation of business and activities)

We would like to raise the concern that such separation could pose a risk to the availability of certain other services such as (ESG) benchmark activities. We believe that such requirement could be reconsidered, as having entities already well established in the rating market, with well-established methodologies and practices also in the evaluation of ESG factors, may give an added-value to a relatively new ESG rating market, facilitating its development. Moreover, ESMA's advice on transparency encourages the increasing integration of ESG data into credit ratings. A new governance structure should ensure that credit rating agencies can use and include ESG aspects in their ratings and vice versa. This provides simultaneous growth and leverages synergies of ratings and rating providers.

Article 16 (Rating analysts, employees and other persons involved in the provision of ESG ratings)

There is a general perception that ESG rating analysts are not sufficiently trained in the assessment of how financial risk may materialize in the underlying business such as, in our case, the banking business in its different facets. Moreover, some may argue that ESG analysts are numerically insufficient to provide the claimed coverage of listed undertakings. The requirements as foreseen in Article 16(1) are welcome but too vague. The article requires that rating analysts "have the knowledge and experience that is necessary for the performance of the duties and tasks assigned". We believe these criteria should be further refined to specify characteristics that, among others, allow to relate ESG ratings to material financial risk to the rated entity – as outlined in recital 21 on the consideration of the multiple dimensions of the double materiality and longer timelines.

Proposal for a new Article 16 bis (Due diligence on controversies / Effective interactions between the ESG Rating and the covered entity)

Agencies have historically not held direct relationships with companies, relying instead on purely public information: whilst this has improved, some agencies still do not provide one dedicated analyst and are keen not to be seen to be 'influenced' by issuer companies. This means that there is no exchange with an analyst whilst they are performing their analyses – no questions are asked when data is not understood leading often to inaccurate conclusions.

Also, companies may not be aware that they are rated by certain ESG rating providers while others are not updated when there are changes to their rating, leading to asymmetry of information and inaccuracies in the reports. The escalation process to report inaccuracies with unsolicited ESG ratings is frequently very slow and time consuming for rated companies, and in some cases may imply obtaining a solicited (fee paying) ESG rating, which means that reports that are be available to investors might not be corrected or updated for many months.

Hence, we suggest **complementing the proposal to ensure an effective interaction between ESG rating providers and covered entities** and that reliable information is disclosed.

Furthermore, controversies can have a huge weighting on overall ratings. Hence, we are supportive of the introduction of provisions requiring ESG rating providers to apply a due diligence processes in order to (i) assess the sources and seriousness of the controversies and (ii) to duly considering in rating the remedial measures taken by the company rated and elapsed time since the controversies (for instance the ESG rating providers should be required to explain why a controversy which dates back more than 5 years with remedial measures still weigh in the rating). The same level of transparency should be required on how controversies are included within the methodologies.

Article 18 (Complaints-handling mechanism)

We support that the proposal establishes an independent complaints procedure under Article 18. Given the growing importance ESG ratings have for investment decisions it is key that issuers have the possibility that their complaints are treated in a professional, independent and timely manner. The time limits for this procedure should, however, be more precisely defined. The wording "timely and fair manner" and "reasonable period of time" may leave excessive room for interpretation.

CHAPTER 2: Transparency requirements

Article 21 (Disclosure of the methodologies, models, and key rating assumptions used in ESG rating activities to the public)

We appreciate the proposal to introduce a disclosure published on the ESG rating providers' websites of the methodologies they use in their rating activities, including the information on whether and how the methodologies are based on scientific evidence whether analysis is backward-looking or forward-looking, and how controversies are considered within the rating. Furthermore, there should be a requirement on the verifiability of the data, including the sources used, as it is the case with the CRA regulation. However, as this market is currently too fragmented and characterized by different methodological approaches with the result of non-comparable ESG rating assessment and judgement, we consider important that homogeneity and comparability should be pursued.

Ensuring comparability among ESG ratings is of utmost importance. In this regard, the requirement for ESG providers to disclose the data they use, including whether it is sourced from standardized disclosure, the objectives of the rating, and the weight assigned to each factor, represents a step forward. However, to further enhance transparency, we propose considering the development of a common master scale that can be applied to ratings with same objectives, assessing the aggregated E, S, G factors. Such a mechanism would facilitate easier and immediate comparisons between comparable ratings, enabling better-informed decision-making processes.

Furthermore, additionally, it should be specifically included in the report on the main findings of the evaluation of the application of the Regulation (as laid out in Article 49) an assessment on the level of the homogeneity and comparability of ESG ratings. Considering this, awaiting five years after the entry into force of the Regulation seems too long to conduct a review; we therefore suggest reducing such a timeframe to 3 years after the commencement. Additionally, the Regulation could explicitly oblige providers to publicly consult on new methodologies or changes to an existing methodology.

Last, we propose the legislation to also include more transparency to the public and to the rated companies on **fees, sources of the data and data "timestamps**".

CHAPTER 3: Independence and conflicts of interest

Article 25 (ESG ratings' fees charged to clients to be fair, reasonable, transparent, cost based and non-discriminatory)

We support the proposed requirement that ESG rating providers shall take steps that are adequate to ensure that fees charged to clients are fair, reasonable, transparent, and non-discriminatory.

Moreover, ESMA may require ESG ratings to be provided with documented evidence and decide to impose fines in case such principles are not met. In order to ensure that such principles are correctly and homogeneously applied, we propose to delegate ESMA to better define when the fees charged to clients can be considered fair, reasonable, non-discriminatory and based on costs.

Furthermore, as for CRA the principle should not only apply to ESG ratings but also to the ancillary services of ESG ratings. ESG rating providers also commercialize research/data which allow to explain their rating. Those services, as for credit ratings, should be subject to the reasonable, transparent and non-discriminatory commercial practices.

In order to ensure an efficient implementation of those principles, ESMA could detail the requirement with regard to fees charged by the ESG rating providers for the ESG ratings, the data and related research, as they did for credit agencies:

- Publication of pricing policy on the website of the provider
- Provision of more detailed fee schedules, which are simplified and standardized, allowing clients to more easily identify the fee charged for each product or service

- Establish policies and procedures governing the fee setting process strengthening the related governance framework, and directly and explicitly linking fee schedules to costs
  Customers of information services companies linked to ESG rating providers should not be charged further fees for the use of ESG ratings for regulatory purposes.

We propose to complement the legislation with Capital Requirement/Insurance for ESG rating providers.

The proposal does not address the responsibility of ESG providers for potential economic losses resulting from erroneous ratings. To ensure that ESG providers are held effectively accountable and able to restore such losses, a possible solution might be introducing an obligation for them to maintain an adequate level of capital or subscribe to mandatory insurance. This would provide a mechanism for compensating for any economic losses caused by inaccuracies in ESG ratings and promote responsible practices within the industry.

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