ERT

Expert Paper

Contribution to the Commission consultation on the transparency and integrity of Environmental, Social and Governance (ESG) ratings and sustainability in credit ratings

September 2023

Introduction

The latest call for evidence[1] (June 2022) of the European Securities and Markets Authority (ESMA) confirmed that the market of ESG rating providers is very fragmented, with 59 providers being active in the EU. This fragmentation and proliferation results in a significant degree of heterogeneity in practices and methodologies as well as a low degree of comparability[2].

ERT also acknowledges, in line with the findings from the public consultation, that over the last few years there have been several mergers and acquisitions within the ESG rating market. This has led to a skewed structure of the market with a small number of very large entities on one hand, and many very small sized entities on the other hand. We notice that most of the larger ESG rating providers with a significant market share are entities based outside of the EU[3].

In the following we would like to comment on the Proposal for a Regulation of the European Parliament and of the Council on the transparency and integrity of Environmental, Social and Governance (ESG) rating activities[4].

We appreciate that many of the key findings of the public consultation as well as concerns from the real economy have been reflected in the proposal. Additionally, we also want to provide our thoughts on further ambitions that drive the more transparent inclusion of sustainability aspects in credit ratings.

1. Striving for a common baseline and level playing field

For a robust and decent assessment of a company's sustainability performance, that leads to a complete and comparable rating outcome, we believe it is vital to establish certain minimum standards or areas that should be assessed and considered for the final ESG rating. We would like to emphasise that sustainability performance ought to be assessed always in the holistic context of a company. This should include all ESG aspects – the environmental, social & societal as well as governance implications – and should also consider sector-specific requirements.

The ESG ratings (and related data) that are available in the market tend to fall short in terms of their usability as their analysis is often mostly backward-looking. To better assess the resilience towards physical and transformational risks, we would stress that ESG ratings should not only focus on backward-looking information and data, but also on existing forward-looking information produced by companies, such as in compliance with the Corporate Sustainability Reporting Directive. In this regard, it is necessary to reflect on the strategic directions, measures and targets of the rated subjects to provide users of ESG ratings with a thorough judgement of preparedness.

This can lead to a robust, comparable, and comprehensible assessment of the transformation of a company.

2. Ensuring regional balance

Like the market for credit rating agencies, the market for ESG rating providers is skewed towards non-EU headquartered entities, mainly due to mergers and acquisitions that happened over the last decade. We believe that it would be adequate to monitor the development of the level of concentration and its effects. Market consolidation should lead to enhanced professionalisation and standardisation, as well as increased transparency and comparability while maintaining the integrity of the ESG market.

We appreciate the proposed provisions as laid down in chapter 3 of the proposed regulation to ensure independence and avoid conflicts of interest. This can certainly help enhance the integrity of the ESG Rating market. The provisions related to 'Conflict of interest' would, however, be improved by considering the relationship between ESG rating providers and issuers/rates entities, since this is where the inherent power imbalance and exposure to conflicts of interest are mostly situated.

Additionally we would like to flag that a geographic balance of ESG rating providers and its headquarters is key to foster good governance, to avoid conflicts of interest and to prevent biases towards certain regions, sectors or industries.

1 European Securities and Markets Authority, "Ref: Outcome of ESMA Call for Evidence on Market Characteristics of ESG Rating and Data Providers in the EU" (link).

2 Berg, Kölbel and Rigobon, "Aggregate Confusion: The Divergence of ESG Ratings", 2019 (link).

3 Eccles, Stroehle, "Exploring Social Origins in the Construction of ESG Measures", 2018 (link).

4 European Commission, "Proposal for a regulation oft he European Parliament and oft he Council on the transparency and integrity of Environmental, Social and Governance (ESG) rating activities" (link).

3. Enhancing transparency and consistency

Each ESG rating agency has its own methodological approach that differs from others available in the market which brings a certain degree of opaqueness. We observe significant divergence between different rating providers' assessments and rating conclusions, mainly due to the specialisation of individual rating providers. They have fundamentally different approaches towards data measurement and data sources, scope of assessment, applied methodologies, and geographic coverage. This very heterogenous rating landscape comes at the cost of comparability.

The divergence of ESG ratings introduces uncertainty into any decision taken based on ESG ratings and, therefore, represents a challenge for a wide range of decision-makers.

Greater transparency and consistency between the applied approaches as well as comparable rating outcomes would enhance reliability, relevance, and acceptance for ESG ratings among all users and preparers of this information.

We hence very much appreciate the transparency and disclosure requirements of the methodologies, models, and key rating assumptions used in ESG rating activities as laid down in the Annexes to the Proposal for a Regulation of the European Parliament and of the Council on the transparency and integrity of Environmental, Social and Governance (ESG) rating activities.

To maximise transparency and comparability, we would urge the Commission to ensure that ESG ratings providers are required to disclose the assessment result at the question level, including the weighting at question level, and to provide feedback to rated entities at this level too.

Given that controversies have a particularly strong impact on the ratings results, it is vital that rated entities can obtain more information on this area so that they can improve their ESG performance and ensure that information is accurate. Providers should therefore be required to disclose the methodology used to evaluate controversies, whether and how remediation measures are taken into account, the duration of the impact of controversies on the overall score, and a list of data sources used for the rating agency. Due to the strong impact of industry classifications, specific disclosure requirements on how this aspect influences the rating result and how the underlying risk scoring is defined should also be included and controversies reports should be brought into scope of the proposal.

To further ensure the accuracy of information, the authorisation criteria regarding the provision of ESG ratings should be expanded. A criterion should be added to Annex I of the Regulation (and the upcoming RTS) to require ESG rating providers to have a complaint-handling mechanism, which is also accessible to the rated entities. Due to the growing corporate disclosure requirements, including through the EU Sustainable Finance Disclosure Regulation, negative ratings will become increasingly consequential, carrying the risk that a single controversy could become decisive for access to future financing. It is therefore of the utmost importance that rated entities have the possibility to file complaints against a rating that does not comply with the requirement of being "objective and capable of validation" (Art. 14(7)).

Rated entities must have a realistic opportunity to rectify any controversies identified. All too often, rated entities face a situation where ESG providers set out unachievable demands to overcome negative ratings. To ensure the effectiveness and independence of the complaint mechanism (Art. 18), we further propose that ESMA should act as an arbitrator in cases that cannot be solved between the rating provider and the rated entity alone.

4. Fostering reciprocal interaction and timeliness

Many users of ESG ratings are typically contracting for ESG rating products while, in contrast, the rated entities are often evaluated on an unsolicited basis. Entities are usually rated by several ESG rating providers simultaneously, which requires them to dedicate substantial resources to their interactions with these providers.

We believe it is of paramount importance that companies can have free access to the results and the related analysis in case of unsolicited ratings, assuming data are communicated when rating is solicited.

We believe that a close and reciprocal dialogue is most useful to ensure that all information is reflected correctly and up to date. We would emphasise that timely responses by the rating providers and structured feedback loops are critical for the accurateness and meaningfulness of the rating outcomes. Ratings that are solely based on currently publicly available information often tend to misinterpret certain aspects and could potentially be biased by distorted media coverage (often only snapshots) or public debates. Comparability in ESG ratings can also be distorted if an ESG rating agency takes into account a mix of public and non-public information that differs between rated entities. Given the vast amounts of ESG information that will soon be publicly available due to the European Sustainability Reporting Standards (ESRS), and to ensure consistency with the materiality principle, the regulation should also include a provision to prevent ESG rating agencies from requesting information deemed immaterial by a rated entity.

Timely updating of underlying data and information is critical for the credibility, applicability, and meaningfulness of ESG ratings. Therefore, whilst we strongly welcome the new ESMA supervisory requirements, we also highlight the importance of this additional level of governance not resulting in assessments being delayed, as this would risk the timeliness and accuracy of entities' ESG score.

A regular feedback mechanism between the ESG rating provider and the rated entity should therefore be formally established. This would offer the possibility to jointly review the data, before the complaints-handling mechanism described in Article 18 of this Regulation is activated. This feedback mechanism would allow the rated entities to timely review and correct the data whilst the exchange with the rating agency would allow a better understanding of how the rating was calculated and on which available data was used and which is in line with the spirit of this proposal.

Structured and streamlined processes can help to avoid erroneous inputs and optimise the mutual information and feedback flow.

The European Round Table for Industry (ERT) is a forum that brings together around 60 Chief Executives and Chairs of major multinational companies of European parentage, covering a wide range of industrial and technological sectors. ERT strives for a strong, open and competitive Europe as a driver for inclusive growth and sustainable prosperity. Companies of ERT Members are situated throughout Europe, with combined revenues exceeding €2 trillion, providing around 5 million direct jobs worldwide - of which half are in Europe - and sustaining millions of indirect jobs. They invest more than €60 billion annually in R&D, largely in Europe.

This response is submitted by the Expert Group on Sustainable Finance of the European Round Table for Industry.

More info and previous papers are available on: https://ert.eu/focus-areas/finance-and-taxation/

Contact: Philippe Adriaenssens (philippe.adriaenssens@ert.eu)

+32 2 534 31 00
contact@ert.eu

@ert_eu
www.ert.eu

Boulevard Brand Whitlocklaan 165
1200 Brussels, Belgium