EUROSIF CALLS FOR A PROPORTIONATE REGULATORY FRAMEWORK FOR ESG RATINGS PROVIDERS

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Today, Eurosif sent its response to the European Commission, responding to the public consultation on the functioning of the ESG ratings market in the EU and on the consideration of ESG factors in credit ratings [link]. Eurosif welcomes the opportunity to comment on the appropriate regulatory regime for ESG ratings providers and data services.

A proportionate regulatory framework for ESG ratings providers

Over the last couple of years, we have seen significant growth rates in the ESG/sustainable investing space. The market for ESG ratings and other ESG data services is growing rapidly to meet a growing and more sophisticated demand from asset managers and asset owners as sustainability matters are becoming ever more relevant to their investment strategies, spurring innovation in the ESG data space. Another factor driving the consumption of ESG data is the introduction of regulatory frameworks such as the Sustainable Finance Disclosure Regulation (SFDR), the EU Taxonomy, the Markets in Financial Instruments Directive (MiFID) and the Insurance Distribution Directive (IDD), which impose significant and granular reporting requirements on financial institutions. These factors are resulting in a significant increase of total costs for ESG-related data for asset managers and asset owners which needs to be closely monitored by policymakers.

In this context, we have the following comments to share on some of the core building blocks of the regulatory framework being considered.

Need for clear objectives: Transparency on methodologies, conflicts of interest and fee structures

The main objective of any regulatory intervention should be to **bring more transparency and robustness on the ESG ratings** provided to the market, thereby creating stronger market incentives to increase the quality of ratings and services made available to investors.

ESG ratings have come under increasing criticism recently due to a perceived lack of correlation between ratings from different providers for the same company, as well surprising outcomes for certain companies expected to score well. Ratings are opinions by each provider, seeking to balance risks, opportunities and sometimes impact dimension across the broad range of complex sustainability factors spanning the whole spectrum of ESG. **Seeking to achieve full comparability and correlation between ratings should not be the stated aim of any regulatory intervention**.

Some of the differences may gradually disappear as a growing number of companies start reporting more granularly on sustainability risks and impacts, following the developing of EU standards by EFRAG and international standards by the ISSB. This is why **putting in place mandatory corporate reporting requirements remains of the utmost importance.**

While more transparency on ESG ratings' methodologies would be welcome, they will inevitably differ. And here it is important to note that **the vast majority of professional investors understand and appreciate the complexity and diversity currently on offer in the market**. These are and will also remain the overwhelming group of users of ESG ratings in the future. **We would caution against any idea that ESG ratings should or will become mainstream for retail investors.**

Additionally, any regulatory intervention should introduce **strong transparency requirements about the monitoring and managing of actual and potential conflicts of interests**. Many of the leading ESG ratings providers are increasingly part of larger groups offering a range of data services which may sometimes bring differing and conflicting interests.

Finally, we believe that **more clarity on a set of basic information on the criteria followed by each individual provider to charge fees** to their (potential) clients would be beneficial to promote efficiency in the market, as well as a mutual understanding of providers' and users' respective needs and expectations.

Immediate focus on ESG ratings, while monitoring market for other ESG-related data services

The aim of any regulatory intervention is to strengthen the transparency and quality of ESG ratings provided to investors based in the EU as these services are playing an increasing role in financial markets. Therefore, at this stage we would focus on ESG ratings.

However, the same consideration on the **robustness and transparency of methodologies is likely to become increasingly relevant for a wide range of other data-related services** around regulatory requirements such as the SFDR, the EU Taxonomy Regulation, the MiFID and the IDD. Other tools such as net-zero alignment tools or Implied Temperature Rise (ITR) metrics will also become increasingly relevant for financial institutions in supporting and underpinning their net-zero commitments and their transition plans, which are likely to become mandatory under the Corporate Sustainability Reporting Directive (CSRD) currently being negotiated. It may be in the future that the integrity and quality of a transition plan will depend on the quality of the scenario, modelling and data services provided to companies.

Therefore, we would urge the European Commission, together with the European Supervisory Authorities (ESAs), to **monitor developments around these services and their quality, and evaluate** – after the adoption of mandatory corporate sustainability reporting frameworks – **whether dedicated regulatory frameworks for a broader range of data services may be necessary**.

Framework should focus on ESG ratings available for sale, not internal ESG assessment

Finally, any regulatory intervention through a new **legislative framework should focus on ESG ratings provided by data providers and made available for sale to third parties**. **The framework should not seek to capture ESG assessments by asset managers or asset owners** that are providing an overlay on ratings by third-party providers. Asset managers and asset owners may produce their own ratings or scores for their internal investment process based on third-party ratings. If these own ratings are a core part of the investment process, transparency will need to be provided on their importance in pre-contractual disclosures under the relevant sectoral legislation and SFDR.

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ABOUT EUROSIF

Eurosif is the leading European association for the promotion and advancement of sustainable and responsible investment making a measurable impact in meeting long-term sustainability goals of the EU and the UN.