ESG data & ratings

Why we need an ambitious European regulatory framework

Paris Europlace & Institut de la Finance Durable Position Paper
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"L'Institut de la Finance Durable" (IFD - Paris Sustainable Finance Institute) is the branch of Paris Europlace dedicated to sustainable finance. It aims to coordinate and accelerate the action of the Paris financial center to achieve the energy and environmental transition.
Both Paris Europlace and the Institut de la Finance Durable contribute to mobilizing Paris-based market players towards a sustainable and low carbon economy, in line with the objectives of the Paris agreement.

As a key part of its Renewed Sustainable Finance Strategy adopted in July 2021[1], the European Commission (EC) initiated a call for evidence,[2] conducted by ESMA, and a targeted consultation on environmental, social, and governance (ESG) ratings and sustainability factors in credit ratings[3].

In its consultation, the EC mentioned its willingness to strengthen the reliability and comparability of ESG ratings and explored the use of non-binding guidelines as well as potential new legislation on the operations of ESG rating providers. Such legislation could potentially set rules for the authorization or registration of ESG rating providers, for more transparency on their operations, methodologies, rules to manage conflicts of interests as well as for a proper supervisory regime at EU level.

Paris Europlace did not take part to the European Commission's detailed questionnaire**.** However, in view of a possible future EC legislative initiative, it seems crucial to raise the attention of the European policy makers on the **key trends of ESG ratings and data products market in the European Union (1), in a context where ESG ratings and data providers are insufficiently regulated (2), and on the need to adopt an ambitious and comprehensive regulatory framework (3)**.

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[1] European Commission, Strategy for financing the transition to a sustainable economy, 6 July 2021
[2] European Securities and Markets Authority, Call for evidence on market characteristics for ESG rating providers in the EU, 3 February 2022
[3] European Commission, consultation document on ESG ratings and sustainability factors in credit ratings, April 2022.

1. The growing importance of ESG ratings and ESG data in a context of market concentration

The market for ESG ratings and data products has been rapidly growing and is expected to continue growing over the coming years. Estimates predict that ESG data and services market "could more than double to over $5 billion by 2025"[4]. ESG ratings are used by a wide variety of investors as part of their sustainable investment strategy. Since the inception of its Action Plan on Sustainable Finance, in March 2018, the European Commission has acknowledged the importance of this topic[5]. However, so far, no legislation covering ESG ratings and ESG data has been set up. Overall, the growing importance of ESG ratings and data services encompasses potential risks for investors and asset managers in sustainable investments. It is even more important to tackle these issues, as the engagement for sustainable and ESG investments is booming.

At the same time, investors and other financial market participants are facing a consolidation in ESG ratings and data service providers, resulting in a concentration of the market on a limited number of large (non-EU) groups, besides the existence of a large variety of significantly small sized providers[6].

Such an oligopolistic situation reinforces the risks of dependence upon a limited number of providers. This could have severe impacts on smaller players in the market, such as higher prices, barriers to entry, which consequently will lead to a lower market competition and less innovation.

2. The insufficient regulation applying to ESG ratings and ESG data providers

First, ESG data is as important as ESG ratings in investment decisions and in regulatory disclosures. Non-financial ratings are mainly sourced by non-financial data. ESG data should not be dissociated from ESG ratings; they are intrinsically linked each together since the quality of ESG ratings can only be guaranteed through the quality of ESG data. In addition, investment decisions and regulatory reporting requirements shall be supported by high quality data. Given the volume of investee underlying and data points, and in the absence of a public open database (that will be only partially solved by the entry into application of CSRD

[4] UBS investment banking, [Future Reimagined: Will ESG Data and Services Demand Accelerate Post-COVID & Who Will Win? | UBS Global, June 2020]

[5] See Action 6 of the EC Action Plan on sustainable finance, March 2018

[6] In June 2022, in its letter to the European Commission titled "Outcome of ESMA Call for Evidence on Market Characteristics of ESG Rating and Data Providers in the EU", ESMA stated that "the structure of the market among providers is split between a small number of very large non-EU entities on one hand, and a large number of significantly smaller EU entities".
ESMA concluded that : "the feedback we have received on the market for ESG rating and data providers is indicative of an immature but growing market, which, following a number of years of consolidation, has seen the emergence of a small number of large non-EU headquartered providers. In our view this market structure bears some resemblance to that which currently exists for credit ratings."

and of the ESAP in the EU), an overwhelming portion of ESG rating users actually also purchase ESG data services[7].

Lastly, unlike financial data, ESG data are not yet subject to international reporting and audit standards. Though there are initiatives in this respect, it will take some time to reach a broad scope in terms of reporting entities, common definitions and data points. This leads to the use of proxies and estimates, and therefore stresses the need for transparency in methodology, not only on ratings but also on ESG data.

Therefore, both topics – data and ratings - should be tackled simultaneously.

Second, a lack of transparency in the type of data and methodology used for ESG ratings is also encountered. It is essential to ensure that products are reliable and transparent to avoid any risk of greenwashing. In addition, the current lack of transparency and, therefore, reliability of ESG ratings and ESG data may lead to investor confusion, which can significantly undermine investors' trusts and confidence in financial products and markets, thus deeply hurting EU objective to protect retail investors. In a context where legal requirements on sustainable finance have substantially increased (SFDR, Taxonomy, etc.), the financial industry encounters huge difficulties to assess whether a product is compliant with the legal requirements it has to comply. This may hamper and even undermine the EU ambition to mobilize retail investors around the 'Fit for 55' initiative and the need to ensure a proper transition towards carbon neutrality. Moreover, cultural specificities also generate a bias depending on the provider nationality and ESG philosophy which does not help when dealing with raw data. These biases and the discrepancy that occurs across methodologies contribute to weak correlation (and high divergence) across scores from different rating companies.

Third, ESG ratings and data providers are subject to an insufficient governance control framework. Some ESG data and rating providers offer advisory / consulting / audit services in order to improve the ESG rating, performance or strategy of a rated company or a portfolio managed by a company. Therefore, when an ESG rating provider also provides such ESG advisory/consulting services to a client, there may be potential conflicts of interest.

At last, it is essential to ensure the effectiveness of EU regulatory requirements that should apply to non EU providers. As a matter of fact, the provision of ESG ratings and data is most often covered by contracts under Anglo-Saxon law and jurisdiction which raises the question of the effectiveness of European rules. How to combine the efficiency of the European regulatory framework aimed to prevail beyond the limits of the territory of the Member States with the contractual framework which is, according to the Common Law, the law of parties? In this respect, the European legislator should be able to impose clauses in certain contracts between an EU user and a third-country provider. In particular, it is essential to make sure that the double materiality concept, that is enshrined in the EU legislation, is well reflected in the ratings and data that are provided by non EU entities.

[7] Refer to ESMA's letter to the European Commission titled "Outcome of ESMA Call for Evidence on Market Characteristics of ESG Rating and Data Providers in the EU" : ESMA letter to the A significant majority of the 66 respondents (42) indicated that they use both ESG ratings and other ESG data products, while 4 respondents indicated to only use ESG ratings and 6 respondents only other ESG data products. 14 respondents indicated to not use either type of products.

3. **<u>Against this background, Paris Europlace would like to formulate the following recommendations:</u>**

We firmly believe that only an ambitious EU legislation could address these issues. We are in favor of an holistic legislative framework that would cover both ESG ratings and ESG data. This legislation would aim at preventing misallocation of investments, greenwashing and ensuring a proper retail investor protection. Indeed, the regulatory sustainable finance framework is meant to cover the entire investment value chain, from the issuer to the distributor of the financial product. Failing to ensure regulatory consistency and clarity along the whole investment value chain can be detrimental to the end investors and increase unintended consequences, such as greenwashing, legal and reputational risks for market players. To this extent, as any major player in the investment value chain, it is crucial that the duties and responsibilities of ESG data and rating providers are well defined within the regulatory framework.

Three essential elements should be the incorporated in this future EU legislation: (i) a solid level playing field framework of transparency, accountability, affordability and governance requirements addressing the different issues listed above, (ii) a proportionate regime for small or intermediate players, (iii) registration of both ESG ratings agencies and ESG data vendors, whatever their current geographical location is, as soon as they provide services for EU entities (companies, citizens, etc.). It is also essential to make sure that this future EU legislation captures both EU and non-EU actors.

Therefore, this future EU legislation should focus on three main objectives:

- **More transparency around ESG ratings and ESG data methodologies**

Enhancing transparency of ESG ratings and data products is key. This implies sharing further information concerning disclosures of applied methodologies. Methodologies and objectives have to be clearly exposed and explained to identify potential bias and avoid any misunderstanding on gaps between the ESG ratings of different ESG providers.

Disclosures should be harmonized as much as a possible, for readability and comparability purposes, and cover: (i) the objectives and the scope of the ratings, (ii) the methodology, models and key assumptions prevailing for the rating, (iii) the type of data sourcing the ratings, (iv), how data is collected, (v) how missing data is dealt with, (vi) the methodology for data estimation/proxies and (vii) control process in general and data quality control in particular. We also encourage more transparency regarding the update cycle for each aspect of the ESG ratings and data products.

- **A better control and governance framework**

An enhanced transparency should also go with an improvement of the accountability and responsibility of ESG ratings and data providers. This is essential to enhance the reliability but also to ensure that a robust control and governance framework is implemented.

In this regard, **ESG ratings and data providers should identify and mitigate any risk of conflict of interest**. Entities should be independent and transparent on their management of conflict of interest. The providers should release disclosures and procedures to address these risks. They should also consider policies to identifying and avoiding potential conflict of interest that may arise.

To avoid any risk of conflict of interest, it is also essential to implement 'Chinese walls' within providers that offer different services to a same client.

- **Addressing the oligopolistic situation of the ESG data market providers**

In order to tackle the oligopolistic situation of the ESG data provider, **it is essential for the EU to adopt the following measures as regards pricing, licensing and contractual issues**: (i) more transparency on fees and licensing terms through publicly available statistics and (ii) fair, reasonable, non-discriminatory and transparent (FRANDT) contractual commercial terms.

These measures should also be complemented by concrete actions aiming to preserve the ability for smaller or intermediate players to enter the market as they can be an innovative force. Indeed, a wider and extended market is key to preserve a diversity of aspects, opinions, as well as FRANDT contractual terms. Indeed, it is essential to preserve a level playing field for small and large providers. Regulation adds a fixed cost on rating production, which favours established providers with a large client base over smaller competitors. As such, it will be important to protect smaller agencies against a regulatory regime that would otherwise unevenly raise the sunk cost of rating production.

Last but not least, the current oligopolistic situation represents a threat for the EU sovereignty. Therefore, and in line with the objective of European Strategic Autonomy, it is essential to ensure that ESG data providers, whatever their location, follow EU standard levels as would EU providers. The current predominance of unregulated oligopolistic non-EU based ESG data & rating providers calls for a strong EU oversight, as well as an opening of the market for smaller EU players.

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To conclude, Paris Europlace is very keen to engage in the debate and remains open to any further discussion in the matter. Considering the growing importance of sustainable finance, we are firmly committed to the subject and are looking forward the forthcoming regulatory framework from the EC concerning ESG ratings and ESG data. We therefore remain at your disposal to exchange further with you and to propose concrete changes in the current EU legislation dealing with the above-mentioned areas.