

Improving the Transparency of ESG Ratings

Deutsches Aktieninstitut supports the proposal for
the EU framework for the ESG ratings market

Deutsches Aktieninstitut supports the EU Commission's proposal for a regulation of ESG rating providers as it is an important step towards improving reliability, comparability, and transparency of ESG ratings and the underlying methodologies and data sources without limiting competition or being overly burdensome for market participants. Although the proposal is well-balanced overall, some adjustments, e.g. with respect to scope, specific transparency requirements and the handling of issuers' complaints are still necessary.

Significant variety throughout the market raises concerns for issuer's access to finance

Over the past decade the market for ESG ratings and ESG information has grown significantly in order to meet the increasing needs of investors regarding ESG data and low transaction costs in the investment process.

However, the fast growth of the market resulted in a heterogenous market structure with different rating providers using different methodologies and operating with differing standards of professionalism and business conduct.

From the perspective of rated entities, whose access to finance and costs of finance are increasingly dependent on ESG factors, this situation raises a number of concerns:

- **Multitude of methodologies:** Because of the diversity in methodologies regarding ESG ratings, a single issuer might be confronted with very different ratings. Though this variety is also an indicator for the ongoing innovation process in this field, it poses a significant additional burden on issuers regarding collecting information for the rating process (see below), handling the interaction with rating agencies and explaining the variety of rating results to stakeholders.
- **Lack of transparency:** Lack of transparency amplifies this problem. Companies often perceive the specific rating process as a black box. Although some agencies try to improve transparency of their methodologies, ESG rating methods and ESG rating providers in general lack transparency and detailed questions on the methodology often remain unanswered. Furthermore, indicators that are included in the rating as well as concrete criteria and expected performance regarding these criteria are not disclosed so that companies struggle to understand what is precisely expected from them in order to improve an ESG score or rating.

- **Controversies as a specific issue:** The handling of so-called “controversies” is a specific and more recent topic that increasingly gains importance. Issuers have made the experience that the existence of a controversial debate may make investors reluctant to invest in securities irrespective of whether a positive headline rating is provided by ESG rating agencies. It may even result in “red flagging”, i.e. excluding the issuer from the investment portfolio. As a consequence, even a single controversy can have an immense impact on how investors evaluate an issuer. From the issuers’ perspective it is therefore of high importance that controversy reports are produced with the highest professional standards and issuers have the possibility to interact with the provider of these reports to ensure a fair and informed evaluation.
- **Data quality issues:** A general observation is also that companies have to spend a lot of time correcting ESG data collected from rating providers, even if issuers become aware of those data errors or incorrectly applied methodologies. Even if providers are open to discuss data quality, the process of interaction does not always appear well-structured or organized and has to happen under significant time pressure. As a consequence, issuers have to allocate a lot of resources to avoid ratings that are misleading because they are based on wrong or incomplete input data or biased interpretations of that data.

Issuers are thus interested in a high degree of professionalism and a high transparency of methodologies in order to better understand which information is used by rating agencies and how it is incorporated in the rating process. Issuers would then be better able to allocate resources to those rating providers with a good and proven track record and a high relevance for investors.

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Against the background of the aforementioned deficits, we support the EU Commission’s proposal for the regulation of the ESG rating market. The obligation for ESG rating providers to apply for an authorisation by ESMA (Art. 4 and Art. 7) ensures that only rating providers will be active in the EU market that are able to comply with minimum standards regarding business conduct, conflict of interest management and transparency. Furthermore, a certain level of oversight is ensured, so that the regulatory standards are met on an ongoing basis.

This general mechanism has proven efficient for providers of financial ratings and is therefore rightly transposed to the market for ESG ratings. Overall, the proposal has the potential to be an important step to address the existing shortcomings of the market for ESG ratings without limiting competition or being overly burdensome for market participants. We therefore encourage the co-legislators to keep the basic structure.

Our comments below summarise our general view on the proposal as well as additional issues that should be considered:

- **The scope needs to be defined carefully:** Though we generally support a clearly defined scope we question whether the scope is already appropriately defined.

First, considering the growing importance of and growing concerns about controversies (see above), it has to be ensured that controversy reports that aim at flagging current or past ESG controversies for investors are in the scope of the regulation. The current definition and scope are not entirely clear in that respect. Furthermore, it has to be ensured that providers of controversy reports work with the highest professional standards and that issuers' complaints are handled with high priority.

Second, care should be taken with respect to a potential overlap in scope regarding research activities of financial undertakings such as banks. It is not entirely clear if for example banks' research activities and other services provided by banks are included in the scope even though they are already regulated by MiFID or SFDR (e.g. the provision for financial advisers in Art. 11 (3b) Delegated Regulation 2022/1288 to disclose whether they rank financial products as well as the methodology used for the ranking and selection process). To provide clarity and legal certainty this overlap should be avoided.

Third, the experiences of issuers and investors are that the line between ESG rating providers and ESG data providers can neither easily be drawn nor drawing such a line is always appropriate. This is due to the fact that ESG data is usually collected and processed by ESG rating providers. Furthermore, ESG Data might also contain elements of valuation or interpretation for which data sources and methodologies are not fully transparent.

It would thus benefit the trust and functionality of the ESG data market if data providers were to be obliged to meet certain standards of transparency and business conduct. Even if we are aware that the proposed regulation does not entirely fit to raw data providers and adjustments need to be made the inclusion of the raw data providers could and should be considered thoroughly.

- **Important complaint mechanism:** We support that the proposal establishes an independent complaints procedure under Art. 18. Given the growing importance ESG ratings (and reports on controversies) have for investment decisions, it is key that complaints by issuers are treated in a professional, independent and timely manner. The time limits for this

procedure should, however, be more precisely defined. The formulations „timely and fair manner“ und „reasonable period of time“ leave too much room for interpretation. In addition, issuers would very much welcome a general possibility to comment on a rating report before it is issued to investors together with an enforceable obligation on rating providers to correct data errors and/or outdated controversies as well as an obligation to apply their methodologies in a consistent and transparent manner.

- **Significantly improved transparency on methodologies (Art 21 and Art. 21 in conjunction with Annex III):** We very much welcome that the proposal significantly improves the transparency of ESG rating providers because the lack of transparency aggravated the problem inherent in the existing variety in terms of professionalism, methodologies and rating results. For this purpose the Commission develops a reasonable two-step approach.

Art. 21 (and Annex III, point 1.) ensures that general information about methodologies, models and key rating assumptions is publicly known. This allows for a better understanding of what can be expected from a specific rating, possible limitations and whether and how methodologies are based on scientific evidence.

In addition and even more importantly, Art. 22 (and Annex III, point 2.) obliges ESG rating providers to disclose more granular information to subscribers and rated entities. Also, ESG rating providers are obliged to react to major new information that might affect a rating. This additional granularity is indeed important for issuers to engage appropriately and professionally with ESG rating providers in order to ensure that evaluations are fair, transparent and reliable. More granular transparency of methodologies, weighting of certain metrics, data sources and processes is also important for investors to understand how ESG rating providers arrive at their scores and to draw the right conclusions from these scores.

However, as mentioned above, one of the key practical problems for issuers currently is that they do not know what precisely is expected from them to meet a (qualitative) ESG criterion. We therefore suggest that this point is tackled in detail. For this purpose Annex III, point 2 or the upcoming regulatory technical standards by ESMA should ensure a disclosure level that allows companies to understand what performance is expected by the rating agency including but not limited to scoring thresholds.

From an investor's perspective it is also important that ESG rating providers (and if included data providers) disclose whether the data used

or shown is reported or non-public data (from the entity), stems from other sources (e.g. media reports or academic research) or is an estimate or proxy and how exactly this information is weighted in an aggregate score.

- **Provision on the separation of activities needs further consideration:**
According to Art 15, the ESG rating business needs to be separated from other businesses, which is justified by the EU Commission with the objective of avoiding conflicts of interests (see recital 22). Among the list of activities mentioned in Art. 15 are the provision of credit ratings and the provision of ESG benchmarks. While we support the objective of limiting conflicts of interests, it has to be acknowledged, that there are groups of companies that offer both ESG ratings and other activities in independent business units. Art. 15 might thus interfere with an existing or developing market structure with respect to these activities. This holds at least true if applied at group level whereas having separated independent units within the same group appears to be more flexible and allowing for innovation. The application of Art. 15 and any potential new governance structure should therefore ensure both limiting conflicts of interests and that benchmark administrators and credit rating methodologies can use and include ESG information.

Contact

Dr. Gerrit Fey
 Head of Capital Markets Department
 Phone +49 69 92915-41
 fey@dai.de

Zelda Bank
 Policy Advisor EU Liaison Office
 Phone +32 2 7894102
 bank@dai.de

Frankfurt Office:
 Deutsches Aktieninstitut e.V.
 Senckenberganlage 28
 60325 Frankfurt am Main

EU Liaison Office:
 Deutsches Aktieninstitut e.V.
 Rue Marie de Bourgogne 58
 1000 Brussels

Berlin Office:
 Deutsches Aktieninstitut e.V.
 Alte Potsdamer Straße 5, Haus Huth
 10785 Berlin

Lobbying Register German Bundestag: R000613
 Transparency Register: 38064081304-25
 www.dai.de

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