Sustainability Blog

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Towards greater transparency in the ESG rating market

The European Commission reacts to the need for regulation and proposes its new framework to address this.

On June the 13th, the European Commission released its proposal for a regulation on ESG ratings. This proposal tackles some of the most prominent issues regarding the ESG rating market and sets a clear focus on preventing conflicts of interest and increasing transparency.

Background

In recent years, numerous discussions and consultations have assessed the state of the ESG rating market and its products (please check out our previous article on the topic). Along that journey, major criticisms have been voiced regarding both the ESG ratings themselves and the functioning of the corresponding market. Finally, on the 13th of June 2023 the European Commission (EC) published its proposal on transparency and integrity of ESG rating activities, representing the first binding regulation to tackle some of the major issues stakeholders had identified.

Commonly voiced issues related to ESG ratings

A lack of transparency regarding the whole rating process starting from data sources used via methodologies all the way to an ESG rating's purpose or scope of application is probably the most prominent issue identified by stakeholders. Also high on the list was a potential conflict of interest where an ESG rating agency also follows other business activities that might be built upon or make use of ESG ratings or where an employee of a rating agency is invested in such ventures otherwise. Thirdly, a lack of oversight created a sense of chaos and a loss of trust into the correctness and usefulness of ESG ratings. Even investigated by a range of academic studies, the correlation between ESG ratings of different providers was remarkably low, which can readily be attributed to the wildly differing models and datasets being deployed. ESG rating outcomes significantly depend on the philosophy that is behind the model, including the extent to which the different components of double materiality are taken into account, on the weights that different aspects or indicators enter the score with, on the actual data being used and several other factors. Last but not least, varying coverage, in terms of both geographies, industries and organizations' size, has been identified as an issue. This is mostly due to the fact that data availability and quality vary between segments.

The proposal tackles the most urgent issues

The proposal, relying strongly on the IOSCO 2021 report and the ESMA 2022 survey findings, offers a particular focus on transparency requirements of ESG rating activities. Stringent and transparent reporting from the ESG ratings providers is expected, both directed at the public and - in even more detail - at specific stakeholders. This concerns information about data sources and the corresponding collection and analysis processes, rating methodologies (including time horizons and prevalence of scientific evidence), aggregation weights, modeling assumptions and the rating's scope, among others. Having unobstructed access to this information - starting from 2028 even via the European Single Access Point (ESAP) - will enable stakeholders and the wider public to better understand and compare different ESG ratings.

Independence and conflict of interests are additional topics at the heart of the proposal. It suggests independence-related obligations for rating analysts, employees and other persons involved in the provision of ESG ratings (e.g., no buying or selling of financial instruments issued, guaranteed or otherwise backed by a rated entity) and requires the separation of ESG rating activities from any other activities carried out by the organization (including the provision of advisory, banking or insurance services, the issue and sale of credit ratings and the development of benchmarks).

Under this new regulation, ESG rating providers will be centrally supervised by the European Securities and Markets Authority (ESMA). Only after ESMA's authorization will such providers be allowed to participate in the market. ESG rating providers from outside the European Union may also receive an approval for selling their products within the EU, if certain conditions are met - basically, those agencies have to be subject to comparable and equally thorough requirements. ESMA receives the power to acquire any information from ESG rating providers that is necessary for ESMA to fulfill its obligations, to perform investigations and on-site inspections. Should an ESG rating provider not comply or adhere to the rules, ESMA may impose potentially drastic measures, such as fines or a revocation of the authorisation.

These three pillars of the new regulation tackle the possibly most pressing issues related to ESG ratings, boosting transparency, integrity and trust. Harmonization of ESG rating models is not a goal of the proposal. While the low correlation of ESG ratings can be regarded as an issue and create a sense of low reliability, freedom in model designs also enables different sustainability angles to be highlighted by different vendors. The new transparency requirements are expected to at least partially alleviate the issue. The availability and quality of the underlying data is not subject to any new requirements either, however, new reporting requirements like CSRD/ESRS, data collection and data infrastructures are expected to improve the situation over time. After all, at least small companies may be rated using a portfolio approach (e.g., averages defined for different industries and geographies).

The new regulation does not apply to all ESG ratings

ESG rating providers that compute ESG ratings for public consumption are the main target of the new regulation. Importantly, internal ESG rating models and raw ESG data provision are not subject to the rules set out therein.

Next steps

Following the publication of the proposal, the European Parliament and Council are expected to agree to the Regulation which will enter in force 20 days after its publication in the Official Journal of the EU. In addition, it is stated that the regulation will find application 6 months after the entry in force.

Under this new regulation, ESG rating providers will have to notify ESMA within 3 months at the date of entry into force of this Regulation if they want to continue their ESG rating activities and will have to apply for an authorization by disclosing e.g, general legal information relating to the structure of the data provider, but also information specific to the rating, such as the number of the analysts, employees and other persons directly involved in assessment activities or the methodologies adopted (Annex I of the Proposal).

Moreover, ESMA is responsible for developing and providing draft regulatory technical standards to the EC specifying the additional information needed to authorise ESG rating providers. Those requirements are expected to be contained in a delegated act published by the EC in the next few months.

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