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**A snapshot insight into the ESG data, research and rating market**

Background document in support of the EC “consultation on the renewed sustainable finance strategy”, questions 17 to 21

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**Disclaimer**

This background document is a response to the Commission’s request “to gather further evidence through this consultation”[[1]](#footnote-1) on ESG market concentration, data, research, rating and regulatory measures (covering questions 17 to 21 of the consultation). This research note provides some additional information and specific points that could not be incorporated in the space of the consultations’ responses. It is uploaded with SOMO’s consultation responses as made possible at the end of the EC’s online consultation format. This research note is only intended for the European Commission, and should not be published or distributed.

This preliminary research note by SOMO cannot be considered as a finalised research report that provides a good overview of the ESG industry and its methodologies. Rather it provides some snapshot insights in particular issues from SOMO’s perspective in order to start an understanding of the business models of a few ESG firms, their corporate structures and practices. By no means does SOMO intend this document to be a complete overview of the ESG market.

Most information in this research note is based on literature while information about the corporate structures has also been retrieved from ThomsonReuters Eikon (Refinitiv) data bases, and corporate annual reports and websites.[[2]](#footnote-2)

SOMO refutes any liability for any information contained in this research note.

**About SOMO:**

The Centre for Research on Multinational Corporations ([SOMO](http://www.somo.nl)) is a critical, independent, not-for-profit knowledge centre on multinationals. Since 1973 we have [investigated](https://www.somo.nl/about-somo/#research) multinational corporations and the impact of their activities on people and the environment. We provide [custom-made services](https://www.somo.nl/about-somo/#services) (research, consulting and training) to non-profit organisations and the public sector. We strengthen collaboration between civil society organisations through our [worldwide network](https://www.somo.nl/about-somo/#network).

**Information related to consultation Question 17. Do you have concerns on the level of concentration in the market for ESG ratings and data?**

**A. Level of concentration**

From different sources about **the use** of the ESG firm services, some ESG firms seem to be used more frequently by investors, although there is no ESG rating that is useful for all investors.

According to a survey by SustainAbility[[3]](#footnote-3) among investors, “Sustainalytics and MSCI were most often mentioned by investors, who favor them for their broad coverage”. “CDP and ISS were often mentioned for quality and usefulness, while ISS is praised most frequently for its governance scoring. The RobecoSAM CSA also was raised by investors as high quality, but the same investors lauding its quality claim it is less useful for investment research than other ratings because access to the underlying data and analysis is so limited. Trucost ESG Analysis, part of S&P Global, and several newer ratings and research providers like Truvalue Labs and S-Ray, which utilize artificial intelligence (AI) to gather ESG data and insights, were also mentioned as deserving attention.”

According to an EBF-IIF survey, the most common data and service providers used by financial firms for their specific climate risk analysis are “2° Investing Initiative, 427, Bloomberg, CDP, MSCI, Navigant (Ecofys), Refinitiv, RepRisk, Sustainalytics, and Trucost.”[[4]](#footnote-4)

An ESG firm from the US, Buzzword, mentioned in 2019 the following raters and rankers as the most used by various financial players: Sustainalytics, MSCI, ISS, RobecoSAM and RepRisk.[[5]](#footnote-5)

In addition, ESG firms might have strategic partnerships with other players in the financial sector. For instance Sustainalytics had not only a longstanding strategic partnership with Morningstar (it is now owned by Morningstar, see below), but also with Glass Lewis, Stoxx and FTSE Russell.[[6]](#footnote-6) Another example is that the Dow Jones Sustainability Index (DJSI) is based on ESG research by RobecoSAM.[[7]](#footnote-7)

The level of **concentration and consolidation of ESG firms** has shown a rapidly growing trend.[[8]](#footnote-8) SOMO research identified that many of the often used ESG firms have (recently) been acquired by large established rating agencies and financial analysis firms:

* Sustainalytics by Morningstar (USA),
* Trucost and RobecoSAM by S&P Global Inc. (USA),
* Vigeo Eiris[[9]](#footnote-9) and “427”[[10]](#footnote-10) by Moody’s (USA),
* KLD4/KLDStats by MSCI (USA)[[11]](#footnote-11)
* Oekom by Institutional Shareholder Services group (ISS, USA)[[12]](#footnote-12)

**B. ESG firms’ business models**

In order to find out more what problems, e.g. of conflict of interest, the growing mergers and acquisitions of ESG firms by credit rating agencies (CRAs) and other firms might create, SOMO did some research into the acquisitions, mergers and integration of the ESG firms in their larger parent conglomerates. SOMO’s data base and literature research provides some insight in the business model by looking at the how the ESG firm operates in the overall corporate structure, as well as the profits, dividend payments and tax payments of the ultimate parent company in which the former ESG firm operates. Below are a just few selected examples:

**1) Sustainalytics BV became a Morningstar (USA) company**

As of 6 July 2020[[13]](#footnote-13), Morningstar Inc. has completed its full acquisition (100% ownership) of Sustainalytics BV (was headquartered in The Netherlands). Morningstar had already used for some years Sustainalytic’s ESG ratings for its investment research services (namely for Morningstar's Sustainability Rating for funds and Morningstar Indexes).In January 2019, Sustainalytics itself had acquired GES International, a service provider to institutional investors related to engagement, screening and fiduciary voting services to institutional investors.[[14]](#footnote-14)

Within the corporate structure of Morningstar, Sustainalytics sits as a level 1 subsidiary, at the same level as Morningstar Credit Ratings LLC, Morningstar Global LLC and other level 1 subsidiaries.[[15]](#footnote-15)

After the acquisition, Morningstar plans to continue to “invest in Sustainalytics’ existing business while also further integrating ESG data and insights across Morningstar’s existing research and solutions for all segments, including individual investors, advisors, private equity firms, asset managers and owners, plan sponsors, and credit issuers.” “Sustainalytics also works with hundreds of companies and their financial intermediaries to help them consider sustainability in policies, practices and capital projects.” [[16]](#footnote-16) Morningstar bought in May 2019 DBRS, considered the fourth biggest ratings agency behind the big three of Moody's, Standard & Poor's and Fitch.[[17]](#footnote-17)

In April 2020[[18]](#footnote-18), Morningstar Inc. (USA) was owned for 49.62% by Joe Mansueto, 4.41% by the Vanguard Group via its funds, 4.51% by FMR LLC via its funds and 4.1% by Virtus Investment Partners Inc via its funds. All shareholders received $ 47.8 million in dividends after Morningstar had net profits of $ 292.9 million in 2019 based on an annual revenue of $ 1.18 billion.[[19]](#footnote-19) The effective tax rate was 23.1% in 2019.[[20]](#footnote-20)

**2) Trucost and RobecoSAM acquired by S&P Global Inc. (USA)**

S&P Global Inc. acquired **Trucost plc** in 2016. Trucost provides services of carbon and environmental data and risk analysis. “In 2018, Trucost was integrated from Indices to Market Intelligence”.[[21]](#footnote-21)

S&P Global Inc. integrated the specialized ESG business part of **RobecoSAM** in January 2020.[[22]](#footnote-22) The acquisition was announced in November 2019 through a divestiture by ORIX (Japan), owner of the Robeco Group (now part of ORIX Corporation Europe NV).[[23]](#footnote-23) The SAM ESG Ratings and SAM ESG Benchmarking business units were transferred from RobecoSAM AG to S&P Global Switzerland SA, Zurich branch, from where they will operate, including the SAM CSA (CSA stands for Corporate Sustainability Assessment).[[24]](#footnote-24) RobecoSAM and Robeco will continue to have access to the CSA data to “focus on the interpretation and application of ESG data, as well as sustainable investing research for its core asset management activities.”[[25]](#footnote-25)

The ESG methodology committee for the Corporate Sustainability Assessment (CSA) is formed by representatives of S&P Global and RobecoSAM. The ESG focus is on financially material criteria.[[26]](#footnote-26) “The CSA will form the foundation of S&P Global’s ESG research across its different divisions” [[27]](#footnote-27), namely three of its four divisions/ segments/business units: S&P Global Ratings (“Ratings”), S&P Global Market Intelligence (“Market Intelligence”), and S&P Dow Jones Indices (“Indices”).[[28]](#footnote-28)

S&P Global’s top 20% of shareholders are Vanguard Group via its funds at 8.98%, Blackrock Inc via its funds at 7.68%, and State Street Corporation via its funds at 4.80%.[[29]](#footnote-29) In 2019, S&P Global[[30]](#footnote-30) had net revenue of $ 6.7 billion and a net income of $2.35 billion, and paid 21.5% in taxes and $ 560 million in dividends.

**3) Refinitiv**

Refinitiv is a large provider of data and infrastructure about financial markets. [[31]](#footnote-31) The ThomsonReuters Eikon databases offered by Refinitiv, provide ESG scores for the companies in its databases (see below Q18).

Refinitiv Holdings Ltd. is 45% owned by Thomson Reuters and 55% owned by a consortium lead by BlackStone with co-investors Singapore’s GIC and the Canada Pension Plan Investment Board.[[32]](#footnote-32) Currently, the London Stock Exchange Group is in process of buying the majority stake from the BlackStone consortium, awaiting approval of EU competition authorities.[[33]](#footnote-33) Since 4 March 2020, Woodbridge CO LTD - a private company and the primary investment tool for the Thomson family members- is the principal controlling shareholder of Thomson Reuters with approximately 66% ownership.[[34]](#footnote-34)

In 2019, Thomson Reuters’ operating profit was $ 1.2 bn and had $ 5.9 bn[[35]](#footnote-35) in revenues, and paid $ 698 million in dividends[[36]](#footnote-36). The effective tax rate was 11%[[37]](#footnote-37). Thomson Reuters has subsidiaries/branches located in tax havens as defined by the Tax Justice Network’s list of tax haven countries. Refinitiv Holding Ltd. is incorporated under the law of the Cayman Islands.[[38]](#footnote-38) Principle subsidiary Bedrijfsbeheer TRA BV is in the Netherlands, LN Holdings Limited, TR Holdings Limited, and TTC Holding Limited are in Bermuda, Thomson Reuters Finance S.A, and Thomson Reuters Holdings S.A. is in Luxembourg, and Thomson Reuters Global Resources Unlimited Company is in Ireland[[39]](#footnote-39).

**C. Conclusion for Q17 of the consultation**

There is a rapid concentration of the ESG market, resulting from a wave of mergers and acquisitions by credit rating agencies and other financial market firms.

The concentration of the ESG firms does not seem to be in a way of forming a few or one large ESG firm. The concentration happens through by mergers and acquisitions of ESG firms by existing large credit rating agencies and financial analysis corporations.

The mergers and acquisition often leads to integration of the ESG firms activities throughout services and products by the new parent corporation. This can easily lead to conflicts of interests within the new parent corporation, especially given the latter’s business model of high profitability and dividend payments, with shareholders of dominant investment funds. Conflicts of interest might also raise when particular negative ESG practices, such as tax avoidance or evasion, by the parent corporation are being practices while they are or are not included in the scope of the ESG data but should.

The concentration of frequently used ESG firms happens by CRAs and financial analysis corporations that are headquartered in the USA. This means that the country of origin on the parent corporations of important ESG firms are based outside the EU (see also Q21 below).

The business model of corporations in which the ESG firms have been integrated shows one of being able to provide high profits for shareholders demanding high returns. The question therefore is how much more investments will be allocated to ESG data gathering, research and ratings, given that the quality still needs huge improvements (see next sections).

The concentration and consolidation results in the same data being used for various ESG services and products, within the parent corporation and beyond through strategic partnerships. For instance, SAM ESG business is fully integrated in the S&P Global business, including its credit ratingsm but in an arrangement with Robeco and RobecoSAM the latter can use the same SAM ESG/CSA data as S&P Global.

**Information related to consultation Question 18. How would you rate the comparability, quality and reliability of ESG *data* from sustainability providers currently available in the market?**

All investors interviewed for the report “Rate the Raters 2020”[[40]](#footnote-40), “expressed a desire for better data.” “Investors want companies to provide better ESG data disclosure, to focus on what is most material to the business and to more fully integrate ESG information into financial statements. Regular reporting, and, where possible, real-time information are keenly desired. Investors also strongly prefer to get ESG data all in one place, ideally via short ESG data or fact sheets instead of long reports. In addition to data, investors want better commentary on how leadership thinks about ESG and how it fits company strategy.” “[C]ompanies need to work towards greater ESG transparency, reporting and consistency especially within sectors”.[[41]](#footnote-41)

In the case of Refinitiv[[42]](#footnote-42), the six sources for the analysis research is based on publically available information, four of which come from the companies themselves: annual reports, company websites, stock exchange filings and CSR reports. Only two publically available information sources are not from the companies themselves: news sources (which does not seem to include social media) and NGO websites.

**Comment**

Over-reliance on ESG data from the companies themselves, or even on publically information, might result in biased and incomplete information.

From SOMO’s experience of corporate research, corporations often report on policies and not on their implementaton, are doing box ticking on ESG issues and report little about impact on people and planet, let alone reporting controversies which they think have no financial (‘material) impact. Impact research on the ground where a company and its supply chain operate, needs a lot of time and careful methods from reaching (but also protecting) affected stakeholders (workers, communities) up to verification of objective data (e.g. tax payment figures) with the corporation. This means that while SOMO and other NGO research reports result from real on the ground impact research and expose controversies, such reports are often a snapshot of the corporation’s impact of its operations around the world.

The question is whether profit making ESG services are willing to make the costs to better investigate the actual impacts and forward looking assessments, in order to to get better data on which to better assess the real sustainability of a company.

In other words, there is still a lot of ESG reporting and impact information missing and thus lacking in all ESG data used for research and rating (see also next sections Q 19-20). More reports from stakeholders, civil society around the world where companies operate and have supply chains, and other independent researchers are needed, but resources are lacking.

**Information related to consultation Question 19. How would you rate the quality and relevance of ESG *research* material currently available in the market?**

Investors surveyed and interviewed by SustainAbility[[43]](#footnote-43) indicated where they were researching for ESG data. The four most useful sources of corporate ESG information were: “corporate ESG ratings, direct engagement with companies, corporate sustainability reports and in-house research.” **“**Most investors described using ESG ratings more for the underlying data and not the scores. Those that have their own internal scoring methodologies and KPIs do not need the scores. What they do need is a way to efficiently gather ESG data to feed these internal scoring and analysis mechanisms.”[[44]](#footnote-44)

There are several references that the staff in ESG rating firms are too small or the human resources allocated to research and analyse for ESG ratings are too limited.[[45]](#footnote-45) “Many investors noted that the seniority and tenure of research analysts that develop ESG ratings is not sufficient. Investors described a business model where research teams are spread too thin and thus do not have a deep enough understanding of the issues and sectors of the companies. Investors want to know they are getting the best analysis from an experienced professional with deep expertise across an industry”.[[46]](#footnote-46) “ESG ratings analysts, who cover hundreds of companies and don’t know them well. They often do a check-box exercise, use AI”.[[47]](#footnote-47) Investors’ ”analysts have 25 years of experience while ESG ratings providers will usually have younger graduates and have them work on a checklist of issues, which may not be critical to the way business operates and generates value”[[48]](#footnote-48)

In their study, by F. Berg, J. Koelbe, and R. Rigobon[[49]](#footnote-49) indicate that the ‘rater effect’ (see below Q 20) could perhaps be attributed to the fact that the ESG analysts are divided by firm rather than by ESG category, thus the analysts having less thorough knowledge of each of the ESG categories.

In the case of Sustainalytics, a Morningstar company, its ESG research and rating business “offers data on 40,000 companies worldwide and ratings on 20,000 companies and on 172 countries.”[[50]](#footnote-50) It “has 16 offices globally, has more than 650 staff members, including more than 200 analysts with varied multidisciplinary expertise across more than 40 industry groups”.[[51]](#footnote-51)

Refinitiv[[52]](#footnote-52) explains that the research to get the ESG data (in the ThomsonReuters Eikon data base) is done with a staff of more than 150 “content research analysts trained to collect ESG. This staff is based in in Gdynia (Poland), Beijing (China), Bangalore (India), Mauritius and Manila (The Philippines). They are covering 9000 companies from all over the world. The “analysts process manually for each company within the ESG universe”. They do that throughout the year to continuously update the ESG data base. A standardization process with automated checks for errors and quality, sample audits, weighing factors (e.g. size of the company) and automated quantitative score updates follow the data hunt, to ultimately come to an overall ESG score.

**Comments**

Based on the figures provided by Morningstar and Sustainalytics (see above), SOMO calculated that if there would be 200 full time Sustainalytics’ analysts, each analyst on average rates around 100 companies and provides ESG data on average of 200 companies. Calculated for a year of 220 working days (ca. 11 months) a year, that means that each analyst is rating is on average each company during 2.2 days a year, and ESG data being provided on average 0.9 days per analyst per company.

Based on SOMO’s calculations of the above-mentioned information provided by Refinitv, each ESG analyst has to cover on average 60 companies. The ESG analysts are based in law wage countries and not in one country for the whole team. Given that four of the six sources of ESG data are based on company information[[53]](#footnote-53), there should be questions about the reliability of those data and related research.

As far as can be deduced from the literature and information about the analysts, none of the sources are based on verification and impact research on the ground where the company and its supply chain operate.

The ESG data and research information have to fit into the computerized systems with numbers and ultimately one indicator (in the same way as credit ratings), suitable for the cost cutting business models of the financial sector.

The insufficient human and financial resources for the ESG data gathering and research might be a consequence of the profitability model (good profits and dividends, competitive prices) of the ESG firms and their parent corporations

**Information related to consultation Question 20. How would you assess the quality and relevance of ESG *ratings* for your investment decisions, both ratings of individual Environmental, Social or Governance factors and aggregated ones?**

In their thorough comparative research paper of six rating firms (Sustainalytics, RobecoSAM, Asset4, Vigeo Eiris, MSCI and KLD), F. Berg, J. Koelbe, and R. Rigobon[[54]](#footnote-54) explain the divergence among current ESG ratings of companies. The rating differences are explained as mostly being the result of divergence in **measurement,** because the ESG rating firms measure the same issue (“category”, “attribute”, e.g. labour practices) with different indicators that produce a numerical value, e.g. workforce turnover or number of labour-related court cases. This measurement divergence is most noticeable for the issues human rights and product safety. The second important reason for ESG rating divergence is the considerable divergence in **scope,** because the ESG rating firms select a different list of issues. Issues that were integrated by three or less rating firms were, for instance, lobbying, taxes, unions, and forests.[[55]](#footnote-55) In a few cases, the ESG rating firms came to opposite conclusions, e.g. on lobbying. Of a lesser importance is the divergence in **weighing** of each of the issues and indicators, which together form the overall rating. What is also likely to play a role, is who is rating (“**rater effect**”) because a company that gets a good score in one category, is also likely to have good scores in the other categories.

The divergence is least for the environmental dimension (correlation average 0.53), somewhat more for the social dimension (correlation average 0.42) and most for the governance dimension (correlation 0.30).[[56]](#footnote-56)

The research by F. Berg, J. Koelbe, and R. Rigobon[[57]](#footnote-57), also reveals that measurements can diverge between indicators that relate to corporate ESG policies (which do not reveal actual practices) and actual outcomes and impacts (e.g. work accidents).

The researchers comment that scope divergence reflects that ESG ratings diverge on what is considered to be relevant ESG categories. This might also still be the case by the users of ESG ratings, who might have different opinions and preferences of what is important as ESG. The confusion is especially created when the same issue is measured differently, as is the case for Human Rights and energy. This could result in companies improving on particular issues but not seeing that reflected in particular ratings.

SOMO comments are that the above measurement divergence does not clarify whether the rating reveals the ESG impacts or ESG risks that are financially material for the company, whether the ESG issues integrated relate to doing no harm, or what contributes to fighting climate change/aligning to the Paris agreement and diminishing human rights and social abuses. When examining the issues that show important divergence in the above-mentioned research paper by F. Berg, J. Koelbe, and R. Rigobon, it is important to expose whether they related to issues that might play a role in the future such as biodiversity, resource efficiency, social security and living wages, privacy and IT, shareholders and taxes. The issue of privacy and IT, for instance, was only included by four of the six ESG rating firms researched by F. Berg, J. Koelbe, and R. Rigobon.[[58]](#footnote-58) Payment of taxes might become a focus as it will be important to fill the public budget deficits due to COVID-19, but the rating firms show large divergence in their measurement (almost zero correlation on tax issues.[[59]](#footnote-59))

The measurement divergence in Human Rights in ESG ratings is worrying because 70% of the 75 large asset managers who were questioned by ShareAction[[60]](#footnote-60), responded that they rely on external data providers for ESG data, with very few conducting own assessment of investee companies about indicators relating to Human Rights and labour rights. The researched asset managers showed a ”very limited ability to identify salient human rights impacts of their investments”[[61]](#footnote-61) beyond general policies. Moreover, the majority of these asset managers have a weak or non-existent approach to engagement on human rights.[[62]](#footnote-62) The ShareAction research exposed that “asset managers lack sufficient due diligence processes to appropriately identify salient negative human rights impacts. Only seven (nine per cent) asset managers were able to identify negative impacts that may be a result of their investments.”[[63]](#footnote-63)

SOMO comments that ShareAction’s research could mean that ESG rating firms will not be hard pushed by their client asset managers, i.e. “the market”, to improve their measurement, scope and rating on Human Rights. Since “Asset managers are addressing human rights issues only where they have identified financial risk, while failing to account for salient human rights impacts”, the ESG ratings might be playing a not so important role in sanctioning or improving corporate behaviour through investment choices based on current voluntary ESG criteria on human rights.

In the survey “Rate the Raters 2020”[[64]](#footnote-64), investors using ESG ratings “expressed strong critiques of ratings, from inaccuracies and use of old or backwards-looking data, to more fundamental concerns about whether ESG performance can ever be distilled into a single score. Investors also complained about holes in corporate data and the need for companies to improve disclosure, reporting and transparency.” They “believe that their own research analysts know better than ESG rating analysts, often because ratings research teams don’t have as much experience and are spread too thin.”

None of the investors interviewed for Rate the Raters state that ESG ratings are excellent because they had a series of critiques[[65]](#footnote-65), such as: errors and inaccuracies which leads to holes in the analysis, old data, different figures for the same issue of the same company (e.g. carbon emissions), missing existing information and reports, evaluating past performance and thus backwards looking, and too much automated/robo produced reports. There is no single rating firm which investors fully trust, and therefore rhey often use different ratings and their own research were possible.

It is not be noted that “many investors expressed concern that their peers may be hiding behind ratings as a quick fix or box checking exercise, using them as a substitute for fundamental ESG research and analysis other investors do themselves. Investors perceive the reason such shortcuts are taken to be, at least in part, a rush to meet growing demand for ESG investment products, and point out that this risks quickly-created, poor quality products undermining demand longer-term.”[[66]](#footnote-66)

Taking just one example in practice, the ESG data expressed in scores by the Refinitiv data base[[67]](#footnote-67) use 450 different ESG metrics that are being used for data-driven processing that combines environmental, social and governance scores (ESG scores) with the ESG controversies score. Through different weighing (e.g. regarding size of the company, country of headquarters) and calculations the ESG scores to get at an overall ESG score. All these ESG scores are updated weekly but not the historical scores of before 2016. There is focus on materiality rather than impact.

SOMO comments that a lot of Refinitiv automated calculations and weighing based on numerical ESG metrics are determining the ESG score, which makes it difficult to get a realistic picture of a company’s implemention and impact of ESG issues. The ESG score does not seem to reflect the forward looking sustainability of the company (e.g. climate scenarios, future targets).

Another example are the ESG ratings being applied at fund level. In the case of Morningstar[[68]](#footnote-68), ESG ratings applied at fund level incorporate another proble. In the case of Morningstar, an average performance is rated for the whole fund, which can include both companies with a strong sustainability performance and, problematically, companies with significantly harmful impacts on the ground. Retail investors are informed with such ratings, but as experienced in the Netherlands, when research exposes that their money is being invested in very unsustainable companies, they are disappointed or opposed to such rated funds, which strongly weakens the credibility of ESG ratings.

**Information related to consultation Question 21. In your opinion, should the EU take action in any of these areas? Explain why and what kind of action you consider would address the identified problems. In particular, do you think the EU should consider regulatory intervention?**

In order to deal with the growing level of concentration, the EU and member state competition authorities should monitor, and were need be, consider how to use EU competition policy regulation.

Given that various EU laws require the consideration of ESG risks and factors to be reported and used, it is necessary to regulate the ESG data/research/rating business.

Research mentioned above reveals amongst others that:

* There is a lack of transparency about the ESG data used, their measurements and the scope, which makes it difficult for investors to assess what the particular ESG risks and/or impacts are.
* The ESG analysts are too thinly allocated per company that is being researched and rated, with use of automated systems; they might be based in different parts of the world, especially seeming to be in cheap labour places.
* There is a lack of trust in the current ESG ratings, so that investors tend to use different ones, in addition have an in-house ESG research team (what is a good idea); more worrying is that ESG ratings are used by those wanting to easily develop ESG financial products without thorough research (which competitors might do).
* There are a few ESG firms and data sets that are being frequently used by many investors.
* The frequently used ESG firms are being acquired by the existing dominant large rating agencies, which means that the ultimate owners are not based in the EU. These ESG firms are often being integrated and used in different strategies and products of the mother CRAs.

When regulating ESG data, research and rating firms, the first question is whether to initiate a new EU law or to amend the exiting EU Regulation on Credit Rating Agencies (Regulation nr 1060/2009, as amended by Regulation 462/2013). Given the fact that (a) some frequently used ESG firms are now part of, and integrated in, major existing credit rating agencies, and (b) some ESG factors are or increasingly become material risks which credit rating agencies have to take into account (as required by the ESMA Guidelines issued on 18 July 2019[[69]](#footnote-69)), amending the EU’s CRA Regulation is likely to be the most effective.

Many basic principles of the CRA Regulation should also be applicable to an amended CRA Regulation covering ESG firms and ESG data, research and rating activities such as:

* Transparency about methodologies and models and key rating assumptions
* Disclosure and the presentation of the credit ratings
* Registration and certification
* Organisational and governance requirements; ownership issues
* Operational requirements (code of conduct)
* No conflict of interest
* Supervised and sanctioned by ESMA: with sufficient expertise, human and financial resources.

Regarding the **specificity of the amendments** to deal with challenges and requirements of ESG data (gathering), ESG research and ESG rating, the following would be important ingredients:  
1) Public **transparency** in general, and in more detail to paying clients, about the:

* Source categories of ESG data (e.g. publicly available or not, from the rated company or not);
* Whether, and what, the researched or rated company is reporting on how much of its activities are according to EU taxonomy, as required by NFRD through the amendment in Art. 8 of the EU’s Taxonomy Regulation;
* Whether the data are about ESG characteristics, ESG material risks and/or ESG impacts (the latter being gathered by on the ground investigations and verifications, up to what level of the supply chain) of the company: the purpose would be to give an idea in how far the ESG data, research and rating are reflecting the (long term) effective impact on the environment and society, i.e. sustainability, of the company
* The scope of the ESG issues or categories covered
* The methodologies used for measuring aggregation of ESG data to come to a credit rating[[70]](#footnote-70)
* The frequency of updating of the ESG data
* Whether and how forward looking models have been used

2) The **quality of the staff** allocated to the preparation of sustainability-related products and services, including their level of experience and seniority, and the average number of companies or financial products covered per analyst.

3) The **use of ESG data**, research and ratings: specific attention should be paid to preventing over-reliance on ESG ratings with specification to reduce, or forbid for products with ESG characteristics or sustainable impact claims, the “sole and mechanistic reliance” on ESG ratings (in the same way as Directive 2013/14/EU) requires from various financial players)

4) The use of ESG of climate, the environmental and social **impact assessments** and forward looking models, in order to distinguish between companies with ESG policies that are not verified by their practices, ESG characteristics that might be not more than doing no significant harm, companies’ ESG material risks and companies’ effective sustainability such as harming or achieving the effective alignment with a 1.5°C climate goals or UN SDGs. The purpose would be to avoid greenwashing and wrong impressions of sustainability, e.g. through over-reliance on company ESG information and best-in-class rating.

Given that frequently used ESG firms have become part of non-EU CRAs or other corporations outside the EU, it is important to deal with **third country ESG research and ratings**. Given that in most third countries, there is no, or will not be in the near future, regulation and supervision of ESG firms or ESG divisions in other (rating) firms, regulating third country ESG data, research and rating will not be possible through equivalence of, and cooperation agreements with, third country supervisors (as arranged through Art. 4 and 5 of the CRA Regulation regarding credit ratings). The solution can be to require that all ESG data gathering, research and rating provided in the EU, are subject to EU regulation by requiring that ESG firms and divisions to be incorporated in the EU, so that all activity of ESG data gathering, research and rating is operated according to the EU amended CRA Regulation. If not incorporated in the EU, the problem is that the EU supervisor will need to go and supervise outside the EU. For instance, ESG analyst divisions are often located in different parts of the world.

Given the complexity of the ESG issues, the increasing importance of ESG and sustainability for many EU sustainable finance policies and laws as well as EU policies (green deal, just transition), the experience of non-regulated CRAs before the financial crisis and the divergence of risk weighing by banks based on their internal rating-based approach to credit risk, the EU should be willing to **establish an official independent EU ESG rating agency**. Such an EU ESG rating would provide a standardised model of ESG ratings, which should at least be the minimum requirement and reflecting the EU’s environmental and social definitions. Commercial ESG ratings would be able to diverge and deviate to improve, but the supervisors would have a benchmark from where to start supervising the ESG firms and divisions. Given that China has also created its own CRA, the EU should have the political will to create its EU ESG CRA, while ensuring its political independence as various EU supervisory authorities, and the ECB, are.

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