

**Finance Watch response to targeted consultation
on the functioning of the ESG ratings market in the European Union
and on the consideration of ESG factors in credit ratings**

*Note: The response only covers selected areas and topics from the consultation, in particular:
Part A - ESG Ratings, Sub-section III. Questions on the need for EU intervention
Part B - Incorporation of ESG factors in credit ratings, Sub-section III. Questions on the need for EU intervention (all respondents)*

Part A – ESG Ratings

Background information

ESG ratings are used by a wide variety of investors as part of their sustainable investment strategy to take into account risks and opportunities linked to ESG issues. Consequently, these ratings have an increasingly important impact on the operation of capital markets and on confidence of investors in sustainable financial products. For the purposes of this consultation the term ESG ratings is based on the definition provided in the International Organization of Securities Commissions’ (IOSCO) final report on environmental, social and governance (ESG) ratings and data products providers.

ESG ratings: refer to the broad spectrum of ratings products that are marketed as providing an opinion regarding an entity, a financial instrument or a product, a company’s ESG profile or characteristics or exposure to ESG, climatic or environmental risks or impact on society and the environment that are issued using a defined ranking system of rating categories, whether or not these are explicitly labelled as “ESG ratings”.

Due to the importance and growth of this market, and potential issues identified as to its functioning, in the action plan on sustainable finance, published in March 2018, the Commission announced a study to be conducted to dig further into the specifics of this market.

The study on sustainability-related ratings, data and research (‘the study’) was published in January 2021. The study identified a number of issues pertaining to the functioning of the market of ESG ratings providers, in particular on transparency around data sourcing and methodologies, as only few firms disclose the underlying indicators or their actual weights of their assessment. The study also highlighted issues in terms of timeliness, accuracy and reliability of ESG ratings. Another issue identified related to biases, based on the size and location of the companies. Finally, it highlighted potential conflicts of interest associated

with certain aspects of their work, including where providers both assess companies and offer paid advisory services or charge companies to see their own reports.

As part of the consultation on the renewed sustainable finance strategy, which took place in early 2021, the Commission asked stakeholders about their views on the quality and relevance of ESG ratings for their investment decisions, on the level of concentration in the market for ESG ratings and need for action at EU level. This confirmed the conclusions of the study, Stakeholders indicated that better comparability and increased reliability of ESG ratings would enhance the efficiency of this fast growing market, thereby facilitating progress towards the objectives of the EU green deal.

This consultation will directly feed into an impact assessment that the Commission will prepare in the year 2022 in order to assess in detail the impacts, costs and options of a possible EU intervention. This consultation should help further clarifying and quantifying the main findings from the study and input received from market participants.

On 3 February 2022, the European Securities and Markets Authority (ESMA) published a call for evidence, complementary to this consultation, in order to support the exercise and provide a mapping of ESG rating providers operating in the EU. The call for evidence also looks at possible costs of supervision would these providers become subject to some supervision.

Subject to the result of this impact assessment, the Commission would propose an initiative to foster the reliability, trust and comparability of ESG ratings by early 2023.

This consultation also seeks views from market participants on the use of other types of tools that can be offered by sustainability-related providers, including research, controversy alerts, rankings, etc.

III. Questions on the need for EU intervention

In light of the current situation and recent developments of the ESG ratings markets, and the potential issues affecting it, this section aims to gather stakeholder views on the need and type of a possible intervention at EU level.

a) Need for an EU intervention

Taking into account your responses to the previous sections, do you consider that there is a need for an intervention at EU level to remedy the issues identified on the ESG rating market?

☒ Yes

☐ No

☐ Don't know / no opinion / not applicable

Please explain why:

Refer to our response to the next question.

If you responded yes to the previous question, what type of intervention would you consider necessary?

☐ Non-regulatory intervention (e.g. guidelines, code of conduct)

☒ **Legislative intervention**

☐ Don't know / no opinion / not applicable

Please explain your answer:

The currently prevalent problems on the market of ESG rating providers suggest that a regulatory intervention is necessary. Most notably, these problems include:

- Lack of transparency with respect to the methodologies, including definitions of ESG factors and their coverage in the analysis (e.g. coverage of ESG factors material from the credit risk perspective vs coverage of all ESG factors also those relevant for the ESG impacts of the analysed entity), time horizons covered in the analysis
- Lack of transparency around data used, its quality and reliability
- Lack of transparency around management of the conflicts of interest between rating providers and the entities commissioning research
- Resulting discrepancies between ESG scores/ratings assigned by different providers to companies with very similar profiles.

The nature of these issues suggests that they are unlikely to be resolved by any high level principle-based and rather voluntary measures in the absence of effective (regulatory) obligations for the ESG rating providers.

We deem the following legislative measures necessary:

- Registration and authorisation regime with minimum requirements regarding organisation, conflict of interest management and disclosure of information on data and methodologies
- Establishing a classification of ESG rating providers and corresponding labelling/information obligations to ensure clarity about the purposes and scope of analysis for different ESG ratings (such as inclusion of ESG risks with clear financial materiality vs ESG impacts; inclusion of E, S and G factors). This should prevent the situation where investors are misled by the use of the “ESG rating” assuming it covers all spectrum of ESG factors, e.g. risks and impacts, which is a wide-spread phenomenon at the moment.

Arguably, the objective of a fully-fledged ESG rating should be to cover all spectrum of relevant ESG factors for an entity being analysed and not just those factors, which are material from the financial risk perspective within the time horizon being analysed. This should be the major distinguishing feature between ESG ratings and consideration of ESG risks in the “traditional” credit ratings, as ESG risks should in any case be considered as part of the credit analysis done by the credit rating agencies (CRAs).

- Disclosure/transparency around methodologies and data used in order to provide a clear understanding to the rating users over what is and what is not captured by the ESG ratings.
- Clear disclosure obligations/warnings for the data, which has not been assured but provided by the company without independent validation - at least until assurance obligations are established over ESG data in the EU law.

The above recommendations are in line with the IOSCO recommendations of its report published in November 2021

(<https://www.iosco.org/library/pubdocs/pdf/IOSCOPD690.pdf>).

At this stage, we also recognise the need to balance regulation with freedom to innovate by the ESG rating providers in order to enable development of methodologies and advance the expertise in this area, which is evolving and is expected to grow as the availability, quality and comparability of data increases with phasing in of regulatory disclosure requirements in the EU and outside.

If you responded yes to the previous question, what do you consider should be the prime focus of the intervention?

- ☒ Improving transparency on the operations of the providers
- ☒ Improving transparency on the methodology used by the providers
- ☒ Improving the reliability and comparability of ratings
- ☒ Clarifying what is meant by and captured by ESG ratings, to differentiate from other tools and services
- ☒ Clarifying objectives of different types of ESG ratings
- ☐ Improving transparency on the fees charged by the providers
- ☒ Avoiding potential conflicts of interests
- ☐ Providing some supervision on the operations of these providers
- ☒ Other measures

Please specify the other elements the intervention should focus on and explain what solutions and options you would consider appropriate:

Refer to our response to the question above.

PART B - Incorporation of ESG factors in credit ratings

The provision of credit ratings is highly regulated in the EU as well as globally. Global standards are established by the [IOSCO in its code of conduct for CRAs](#). The EU legal framework regulates the activities of CRAs with a view to protect investors and financial markets by guaranteeing the transparency, independence and integrity of the credit rating process – thereby enhancing the quality of ratings. All CRAs operating in the EU need to register with ESMA, which is the sole European supervisor. Credit ratings used for the purposes stemming from the EU legislation need to be provided by CRAs registered and supervised by ESMA. If a non-EU CRA wants its ratings to be used for regulatory requirements in the EU (i.e. by EU financial institutions), the [CRA Regulation](#) provides for two alternatives, certification or endorsement.

There are a number of EU regulatory requirements related to the use of credit ratings. , in particular, in the [Capital Requirements Regulation \(CRR\)](#) and in the [Solvency Capital Requirement \(SCR\)](#). The European Central Bank also makes extensive use of credit ratings in its open market operations.

Both EU legislation ([Regulation \(EU\) No 462/2013](#)) and the IOSCO code of conduct define precisely the objective of the credit rating: ‘credit rating means an opinion regarding the creditworthiness of an entity, a debt or financial obligation, debt security, preferred share or other financial instrument, or of an issuer of such a debt or financial obligation, debt security, preferred share or other financial instrument, issued using an established and defined ranking system of rating categories’.

In other words, credit ratings assess the likelihood of the default of the rated entity or security. Credit ratings reply to the question: “what is the likelihood of getting my money back?” They are neither investment recommendations nor they determine the value of the rated entity or instruments.

ESG risks may be relevant for the assessment of creditworthiness depending on the sector, geographical location and the entity itself. CRAs methodologies define which factors, including ESG factors, are considered to be relevant for the assessment of creditworthiness and how they are taken into account in the credit rating process. ESMA supervises the soundness of methodologies, which in accordance with the CRA Regulation need to be rigorous, systematic, continuous, based on historical experience and back-tested. In its Technical Advice provided to the Commission in 2019, ESMA concluded that while it is clear that CRAs are considering E, S or G factors in their credit ratings, the extent to which each factor is considered varies by asset class, according to the importance assigned to that factor by a CRA’s methodology. Currently, ESMA is conducting a thorough assessment of how CRA’s methodologies incorporate sustainability risks.

The CRA Regulation includes a number of disclosure obligations in relation to the methodologies as well as individual credit ratings. In 2019, [ESMA conducted a public consultation on disclosure requirements applicable to credit ratings](#). Following the finding on the insufficient transparency on the relevance of ESG factors to credit ratings, one of the

topics of the consultation, [ESMA issued guidelines on disclosure requirements applicable to credit ratings](#).

These ESMA guidelines expect CRAs to identify in their press releases if ESG factors have been key drivers behind a change in the credit rating. CRAs are asked to identify relevant factors, elaborate on their materiality and provide a reference to the methodology or the associated model. The ESMA guidelines came into effect in April 2020.

A recent assessment of the application of the guidelines revealed that the improvement of transparency has been partial. ESMA has analysed press releases over the period January 2019 – December 2020 and compared the number of references to ESG considerations before and after April 2020. The main findings are that the improvement is partial and not uniform.

This consultation builds on the findings of ESMA and the consultation on renewed sustainable finance strategy.

III. Questions on the need for EU intervention (all respondents)

Do you consider that the current trends in the market are sufficient to ensure that CRAs incorporate relevant ESG factors in credit ratings?

☐ Yes

☒ No

☐ Don't know / no opinion / not applicable

Do you consider that the current trends in the market and application of ESMA guidelines on disclosure applicable to CRAs are sufficient to ensure understanding among users as to how ESG factors influence credit ratings?

☐ Yes

☒ No

☐ Don't know / no opinion / not applicable

If you responded 'no' to the previous questions, what type of intervention would you consider necessary?

☐ Further detailing of ESMA guidelines on the disclosure of ESG factors in credit ratings

☐ Further supervisory actions by ESMA

☒ Legislative intervention

☐ While improvements are insufficient, we do not see further scope for EU intervention

☐ Other

Please explain your answer:

The necessity of a legislative intervention is grounded in the fact that the current trends in the market and regulatory and supervisory actions to-date have not been able to ensure that ESG risks are being systematically and consistently considered by the CRAs. Notably, the ESMA study “Mining ESG disclosures in rating agency press releases” (released February 2022) confirmed the inconsistencies in different CRAs’ disclosure and consideration of ESG factors/risks in the creditworthiness assessment/rating actions - this despite the disclosure requirements being in place per the ESMA Guidelines on Disclosure Requirements Applicable to Credit Ratings.

Note that we use the terminology ESG risks here as opposed to the ESG factors to make it very clear that **those factors** need to be considered **which have an impact on the creditworthiness** of the analysed counterparty, as this is the primary objective of credit ratings.

There are a number of reasons for the missing consideration of ESG risks:

- **Data and methodological limitations** to quantify ESG-related risks in a similar manner as it is done for other financial risks. Most notable aspects of these include: lack of common definitions of the ESG factors and corresponding risk metrics, lack of comparable and granular data/disclosures, need for forward-looking data (as opposed to historical data used for financial risk modelling), lack of sufficiently advanced models to quantify ESG risks. Even the understanding of ESG factors as sources of risk relevant for the creditworthiness assessment is still evolving, in particular with respect to the analysis of transmission channels. Comparing the views expressed in the ESMA Technical Advice to the European Commission on Sustainability Considerations in the credit rating market (2019) with those in the NGFS report “Capturing risk differentials from climate-related risks” clearly shows the emerged industry consensus that ESG factors are a source of risk and should be part of the creditworthiness assessment. However, more needs to be done with respect to analysis of their relevance and materiality in each case.
- **Difference between the time horizons** of ESG risk materialisation, which can range from short- to long-term and feature an element of radical uncertainty, and shorter time horizon captured by credit ratings, as most commonly ratings cover one-year horizon. In reality, not addressing the short-term ESG risks leads to accumulation of risk at systemic level, which is in particular the case for climate- and biodiversity-related risks that are recognised to be of systemic nature. Such accumulation will, in turn, lead to a cliff effect of risk materialisation followed by numerous asset devaluations and defaults.
- **Legal limitations in regards to data and methodologies used by CRAs** per the current CRA Regulation, in particular due to the provisions of the Delegated Regulation EU 447/2012, Articles 4(b) and 7. Specifically, these provisions are oriented towards “traditional” financial risk analyses in that they require CRA

methodologies to be “supported by statistical, historical experience or evidence” (Art. 4(1)8b), describe “the historical robustness and predictive power of credit ratings” (Art. 7(2)(a)). These requirements cannot always be satisfied for the ESG risk data, as these have not been collected in the past in a consistent manner based on any common classification of factors, which would allow for statistical validation based on historical data. Climate-related risks, in particular, are of forward-looking nature and as climate change is a progressing development, there will never be past data on the types of risks, which are ahead of us.

Given the nature of the above challenges, it becomes clear that further “soft” guidance, in particular focusing on disclosures, will not be sufficient to ensure consistent approaches by CRAs to incorporate ESG risks considerations into their ratings.

Regarding the possible regulatory intervention, what type of requirements do you find relevant?

- ☐ Press releases: introduce mandatory requirements mirroring the provision of ESMA guidance on the disclosure ESG factors in credit ratings
- ☐ Press releases: in addition to the previous option require CRAs to publish information not only about the impact of ESG factors on credit ratings, but also the lack of it
- ☒ Methodologies: require CRAs to explain the relevance of ESG factors in methodologies
- ☒ Methodologies: require CRAs to take into account ESG factors where relevant
- ☒ Other

If you responded other, please explain:

Challenges in incorporating ESG considerations into credit ratings are explained in our response to the previous question, which also highlights that stronger disclosure requirements have proven insufficient to address the issue. Specific challenges in deploying traditional approaches to measure/quantify climate-related financial risks are further elaborated upon in the Finance Watch report “A ‘silver bullet’ against Green Swans – Incorporating climate risk into prudential rules” (<https://www.finance-watch.org/publication/report-a-silver-bullet-against-green-swans-incorporating-climate-risk-into-prudential-rules/>). Therefore, we should not expect that the CRAs’ credit ratings will be able to fully account for the ESG-related risks in the near future, which has corresponding implications for risk assessment and management processes that rely heavily on the use of CRAs’ ratings such as prudential capital requirements and the Eurosystem collateral framework.

Therefore, legislative interventions should focus on the following:

- **Addressing the most urgent issue of climate-related financial risks**, which are growing with the time of inaction - this includes i) transition risks which are

growing the longer effective transition is delayed and the more disorderly it will be; ii) physical risks of climate-related disruptions, which grow the longer climate change remains unabated and which will inflict damage to our economy and financial system. As explained in our report, referenced above, the most impactful and immediately feasible tool to start addressing these risks are **prudential Pillar 1 capital requirements for financial sector exposures to fossil fuels (in the Capital Requirements Regulation and Solvency II Directive)**. Fossil fuels are a clearly identifiable set of assets on the balance sheets of companies (translating into exposures on the balance sheets of financial institutions, which invest in / finance them). These assets are associated with high risk of stranding as they need to be increasingly phased out in line with the global climate commitments; further, no new fossil fuels can be explored on the net zero path, as per the estimates of the International Energy Agency (e.g. the Sixth Assessment Report of the IPCC cites numerous estimates of stranded assets in the fossil fuel industry). Usage of fossil fuels is also the major factor contributing to the acceleration of climate change and, thus, increasing the systemic risk.

- Developing independent **in-house credit risk assessments by central banks** to be used for the monetary policy purposes (in particular, collateral framework) in order to consider ESG factors in an independent manner and be able to incorporate the systemic risk perspective (refer to the report “Driving sustainability from within” <https://www.wwf.eu/?6071441/Driving-sustainability-from-within>). In order to reflect the particular risks associated with fossil fuel financing, as mentioned above, central banks should incorporate analogous considerations and exclude companies that develop new fossil fuel production projects, from their collateral frameworks as well as other operations including asset purchases and TLTROs (for the details refer to the Roadmap co-drafted by a number by civil society organisations <https://www.positivemoney.eu/2022/04/climate-roadmap/>)

Please explain your answer:

As the second-step action to the regulatory actions above, CRAs should be obliged to take into account those ESG factors in their methodologies, which are relevant for creditworthiness assessment (i.e. ESG risks) and also there should be transparency around how this is being done. Regulators and supervisors should further establish **minimum standards for the assessment of relevance and materiality** of ESG factors to be taken into account, uniform **criteria for ESG data quality and its verification and minimum standards for ESG methodologies** to make sure the outcomes are credible and comparable. Establishment of robust comparable ESG disclosures, possibly aligned internationally, will serve a pre-requisite for the ESG factors being considered by CRAs. In this respect, consideration of transition plans and sustainability-related targets can be made an industry standard for CRAs to assess

climate-related transition risks, once the requirements for those plans are established as per the CSRD and CSDDD.

We understand this work will take time and development of methodologies and standards for CRAs will be a gradual process, which is why we emphasise that the priority should be given to the two regulatory measures mentioned in our response to the question above.

It should be noted that the measures proposed above do not interfere with the methodological freedom given to the CRAs per Article 23 of the CRA Regulation, as they aim at more consistent and systematic inclusion of ESG-related risks (not all ESG factors as such) that may have impact on the credit risk of an entity or an instrument, which is in line with the requirement to “... incorporate all driving factors deemed relevant in determining creditworthiness of a rated entity or a financial instrument”.

Importantly, we also emphasise that the suggested obligation for CRAs to consider ESG does not and should be made to interfere with our proposals to integrate climate-related risks of fossil fuel exposures in the prudential framework. The risks associated with fossil fuel financing are very clearly identifiable and should be addressed without further delays via incorporating them into Pillar 1 credit risk weights in the prudential regulation as a segregated measure. The work to reflect the credit risk component of the remaining ESG-risks for all types of assets should continue in parallel in order to ensure holistic consideration.

Legislative requirements for CRA methodologies should be amended to **allow for the use of forward-looking methodologies and data derived based on those methodologies** (without possibility to validate and backtest assessment models based on historical time series for this type of data), which is key to the assessment of climate-related and possibly other ESG-related risks. Examples of forward-looking assessments and data to be used include estimation of stranded assets based on the EU and international targets of reduction in fossil fuel consumption, analysis of the transition plans and targets under consideration of actual progress made and feasibility of the planned actions, etc.

What kind of risks or merits of the EU intervention do you see?

☒ Provide further clarity on the impact of ESG factors on the creditworthiness of creditors and financial instruments

☒ More coherent approach of CRAs to the incorporation of ESG factors into credit ratings

☐ More coherent approach of CRAs to the incorporation of ESG factors into credit ratings

☒ Others

If you responded to other, please explain your answer:

With reference to the types of interventions we have suggested in our response to the previous question, the merits of the EU intervention on prudential requirements and central banks' independent credit assessments will be, correspondingly:

- Ensuring the identifiable pocket of climate-related financial risks (fossil fuel-related risks) is addressed within prudential framework, thus mitigating potential consequences of the climate-related risks materialisation to financial institutions and the associated risks to financial stability.
- Mitigating climate-related risks on the balance sheet of the Eurosystem, thus ensuring a smoother functioning of its monetary policy. Through its market-shaping powers, Eurosystem can also drive more sustainability efforts for wider market participants.

Overall, both measures will ensure that the financial sector and monetary policy can support transition to a sustainable economy (rather than play a hampering roles in such transition) by managing the risks associated with climate change and associated transition.

Please explain your answer:

We see the points above as merits of the EU intervention. For the details of the explanation refer to our answers to the two previous questions.

What would be the consequences of the lack of the EU intervention?

☐ Market trends are sufficient to meet investors demands for information on the impact of ESG factors on credit ratings

☐ CRAs will respond to market pressure and ensure the incorporation of ESG factors in credit ratings

☒ The existing gap between approaches of CRAs to the incorporation of ESG factors in credit ratings will grow

☒ Concerns about the insufficient incorporation of ESG factors in credit ratings lack of understanding among investors why certain credit rating actions are not impacted by ESG factors

Please explain your answer:

In the absence of methodological and data standards and given the existing challenges, as outlined above, lack of regulatory action will lead to inconsistencies in approaches by different CRAs in incorporating ESG factors coupled with the lack of transparency around this issue.

In addition, the EU financial system continues to rely heavily on external credit ratings - in setting prudential capital requirements under the standardised approach to credit risk in prudential regulation, in determining haircuts and collateral

eligibility under the Eurosystem collateral program, in taking investment decisions by asset managers. In these circumstances, lack of regulatory action to ensure robust consideration of ESG risks in the credit ratings and transparency of approaches will perpetuate the current situation, where ESG-, in particular climate-related risks, are not priced in and not appropriately reflected in the risk management and corresponding capital allocation decisions. This will increasingly result in misallocation of capital, which in particular in case of environmental and climate risks jeopardises the transition and poses a risk to financial stability.