Bologna, 9st of June 2022

UNIPOL GROUP RESPONSE

EU COMMISSION'S TARGETED CONSULTATION ON THE FUNCTIONING OF THE ESG RATINGS MARKET IN THE EUROPEAN UNION AND ON THE CONSIDERATION OF ESG FACTORS IN CREDIT RATINGS

Main issues in the functioning of ESG ratings market

Unipol Group recognizes the importance of sustainability issues, not only due to the growing regulatory attention at European and national level, but also since the Group believes in the concrete contribution that it can provide on these aspects, as one of the leading operators in the Italian insurance market.

Thus, the Group appreciate Commision's intention to start working on initiatives aimed at fostering the reliability, trust and comparability of ESG ratings.

Indeed, the EU intervention is necessary to address several shortcomings that characterize the ESG ratings market.

Lack of definitions and common requirements about methodology, data sources and transparency

Currently the market for ESG ratings and ESG assessment tools is unregulated and unsupervised. In our opinion, the lack of a legally binding definition of these valuations and products and the absence of minimum requirements relating to sources of information and methodologies represents a serious issue, affecting the reliability and the comparability of ESG ratings and ESG data products. Furthermore, there are currently no transparency requirements for ESG rating providers. This results in different level of disclosure about the methodology and data used. Due to the aforementioned problems, investors are exposed to the risk of purchasing products that do not meet the desired ESG characteristics and the broader objective of channelling capitals to support sustainable activities could be compromised. Thus, we see the need to introduce at EU level a regulation for ESG rating market, aimed at defining ESG ratings, identifying the aspects ESG ratings should assess and imposing requirements about the methodology, data sources and transparency. In relation to transparency, we believe that the disclosure requirements should be defined on three main levels:

- transparency on the source of ESG data and the frequency with which data are updated;
- transparency on the methodology used and on any future changes;
- transparency on what aspects of the sustainability performance are intended to be measured by the ESG ratings.

The **lack of definitions and common standards**, together with a not consistent disclosure, results in: (i) great divergences and very low correlation between ESG ratings assessing the same aspects/companies; (ii) little or no understanding of the differences between various types of ESG ratings. This condition may cause relevant consequences for both rated companies and investors.

Divergences restrict rated companies from being able to improve their ESG performance, since they receive mixed signals from ESG providers about which actions are expected and will be valued by the market participants. Thus, their attractiveness for potential investors interested in ESG matters may decrease.

In a specular perspective, for investors it may be confusing to receive different ESG evaluations for the same companies. The lack of transparency about the reason of these differences may generate doubts on which company to invest in. As a result, the scope of eligible companies may be reduced, causing a negative impact on the risk/return opportunities for the investor.

Biases

We believe that **ESG ratings are prone to be biased on the industry/sector of the company rated**. Indeed, the great majority of sustainability-related ratings normalize ratings by industry to account for materiality changes by industry. This methodology could lead to biased ratings by industry/sector of activity, as opposed to company-specific risk that the sustainability-related ratings should account for. In our opinion, it is an extreme simplification to assume that companies in the same industry face exactly same risks, since in reality each company has a different risk profile depending on their business model. An example of industry/sector bias is represented by the low ESG ratings attributed to companies operating in energy-intensive sectors, for instance IT sectors.

Another **relevant bias is related to the size of the company rated**. Indeed, large cap companies generally show high ESG ratings[1]. The reason for this may be that ESG disclosure could be a burden for smaller companies, which are less able to absorb high fixed costs of such reporting. By contrast, large capitalised companies have a certain degree of expertise on disclosures, and may also have the ability to invest in sustainable "opportunities" that would lower carbon footprints and engage in green opportunities.

An instance of limited communication by small cap firms, that can contribute to the ESG ratings bias, is relative to CO2 emissions reduction targets: only 2% of small and medium-sized European Economic Area firms (i.e. firms whose market capitalisation is below EUR 200 million)[2] have a CO2 emissions reduction target, in contrast to more than 80% of very large European Economic Area firms (i.e. firms whose market capitalisation is greater than EUR 20 billion).

It should also be considered the fact that large companies generally have a higher number of analysts covering

[1] Boffo, R. and R. Patalano (2020), 'ESG Investing: Practices, progress and challenges', OECD Paris (link).
[2] ESMA (2021b) Report on Trends, Risks and Vulnerabilities - No. 2 (link).

them, which often results in more information available.

The introduction of common methodologies at EU level should address this issue, by calibrating the models in order to avoid biases.

Concentration

Another issue of the ESG ratings market is the high level of concentration: even though the demand is reaching significant volumes, there are only few private providers operating on the offer side.

The main reason why the market has reached such a high level of concentration is the need of financial market participants to have access to a huge amount of ESG data, in order to comply with the regulatory requirements they are subject to. The market expresses a demand for a vast ESG data coverage. As a consequence, on the offer side of the ESG data market, **providers coming from the credit rating sector have imposed their presence as main competitors, which can exploit synergies thanks to the use of resources** (data, processes, methodologies, etc..) already available for credit ratings. This phenomenon is very concerning for EU, also in a capital market perspective, because the few small EU providers of ESG ratings have been acquired by big non-EU credit rating providers. Thus, at the moment the European market of ESG ratings is dominated by big non-EU credit ratings providers.

Furthermore, the strong market power of ESG rating providers could compromise the interest of the clients, who are often "forced" to accept their conditions, since there are not valid alternatives on the market. One example is represented by the common case where the provider requires negotiating any litigation in a jurisdiction outside Europe, often in USA or UK. This is presented as a necessary condition for contracting. We would like to stress this point because we believe that clients contracting with providers active in EU should not be forced to set any future litigation in a jurisdiction outside EU. One solution could be to introduce in EU regulation the obligation - applicable for contracts with ESG providers active in EU - to identify a jurisdiction in EU where negotiate any future litigation.

Furthermore, it should be also taken into consideration that the strong market power of ESG rating providers enables them to impose high prices, increasing the burden for clients.

Considering the reinforcing dynamic of concentration, with ESG rating providers integrating with non-EU credit rating providers, the market power on the offer side and the consequent i**ncrease of costs for clients is likely to become even more relevant in the long run**. The oligopolistic structure of the market, together with the low level of transparency and reliability of ESG ratings and evaluations, can determine an increase of the systemic risk for EU financial markets in case the quality of the ESG information – on which the whole market relies – is poor.

For all the above-mentioned reasons, we consider of paramount importance that the issue of market concentration is address by an intervention at EU level.

Integration of ESG factors in credit ratings

Although many CRAs have incorporated rating agencies that are specialised in ESG ratings, there has not been yet an integration of the methodology used for ESG ratings in the credit rating process. Indeed, in most cases, despite of the acquisition of an ESG rating provider by a CRA, the process followed to incorporate ESG evaluations in the credit ratings remains different and independent from the methodology for ESG ratings.

Consequently, **ESG evaluations in the credit rating of a company may differ from the ESG rating attributed to that company by the same provider**. The inconsistency of the abovementioned evaluations is likely to cause confusion both for the company rated and for investors.

Moreover, in relation to the evaluation of insurance companies, the ESG assessment currently does not affect either positively or negatively the credit rating.

We believe that the EU intervention should address the abovementioned issues, by introducing common standards aimed at guaranteeing (i) consistency between ESG ratings and the integration of ESG factors in credit rating evaluation and (ii) the consideration of ESG factors in the outcome of credit ratings.

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