

Institute for Energy Economics and Financial Analysis (IEEFA)’s feedback on the European Commission’s proposal for a regulation of the European Parliament and of the Council on the transparency and integrity of Environmental, Social and Governance (ESG) rating activities

30th August 2023

The Institute for Energy Economics and Financial Analysis (IEEFA) welcomes the European Commission’s significant effort in developing the proposal for a regulation of the European Parliament and of the Council on the transparency and integrity of Environmental, Social and Governance (ESG) rating activities (the Regulation) and the opportunity to respond to the consultation. IEEFA largely echoes the reasons for and objectives of regulating ESG rating activities outlined in the proposal. In October 2022, IEEFA published its own report “[Greater ESG Rating Consistency Could Encourage Sustainable Investments](#)”. The report analysed current ESG rating practices and their shortcomings, and recommended ways to address the issues, including the need for a regulatory intervention in this sector. IEEFA recognises the Commission’s overall initiative as a breakthrough towards addressing some issues relating to transparency and integrity in the ESG rating industry.

Given the European Union (EU)’s influential power on the world’s regulatory development, IEEFA expects the Commission to set a high standard complementing various ongoing EU sustainable finance initiatives to form a nuanced framework. In response to the consultation, this paper focuses on discussing the areas in the proposal that need strengthening and clarifying as identified by IEEFA, and organises as follows: (I) description of an ESG rating responding to Title I; (II) organisation requirements and rating processes responding to Title III Chapter 1 and Chapter 3; and (III) transparency requirements responding to Title III Chapter 2.

I. Description of an ESG rating

While it is appreciated that ESG rating providers can have their own approaches and definitions towards ESG ratings and develop various related products to serve market needs, it would be beneficial for the financial markets if the Commission gives some guidance on what an ESG rating should reflect. Importantly, the proposal – being a building block of the EU sustainable finance framework – should emphasise ESG ratings’ coherence with the principle of **double materiality**. For example, ESG rating providers should be encouraged to consider temperature alignment assessments as a core element of an ESG rating, which is essential to

align with the overarching policy goals of the European Green Deal¹; Information such as transition plan, actions and targets related to climate change mitigation—despite being disclosed under the Corporate Sustainability Reporting Directive (CSRD)—may not be considered in an ESG rating. Further, the Regulation does not illustrate in detail how the EU Taxonomy relates / should relate to ESG ratings. The Commission should consider setting out guidance beyond mandatory transparency requirements aiming to encourage the use and supply of the aspects of **impact** ESG ratings, given its limited offering to date comparing with **risk** ESG ratings².

Table 1 below shows our specific concern of the proposed scope and Table 2 points out the clarification required regarding the proposed definitions.

Table 1 – IEEFA’s feedback on the exclusion outlined in Article 2, paragraph 2

Exclusion proposed by the Commission	IEEFA’s feedback
second-party opinions on sustainability bonds	This broad exclusion of second-party opinions (SPO) would create a regulatory loophole, unless this matter is immediately addressed through EU Green Bond Regulation ³ and other regulation in a mandatory and detailed manner. While the EU Green Bond Regulation covers various grounds including transparency and conflict of interest around “external reviewers”, the providers who review non-“EuGB” bonds – including non-designated green, transition, social bonds and any sustainability-linked bonds alike – may potentially fall out of scope, but those assessment reports published by them may well still be used by an increasing number of debt investors and other stakeholders. SPO reports – which can assess not only on a sustainability bond issuance but also a generic sustainable financing framework – often contain some forms of “ <i>opinion</i> ” that may fit the definition in this proposed text, and the providers can flexibly decide to use and present a lot of processed information that may overlap with or act as an input for ESG ratings (e.g. considerations of overall rated entities’ sustainability strategies, overall capacity of risk management and project evaluation controls, the share of projects’ impacts in overall impacts of a rated entity, the considerations of materiality when it comes it sustainability-linked facilities’ selection of key performance indicators, etc.). The SPO services are often solicited ⁴ – provided under an ‘issuer-pays’ business model, and thus are exposed to business separation or conflict of interest concerns – at times far more exposed than some “ <i>score</i> ”-like products.

¹ The European Commission. European Green Deal, COM(2019) 640 final

² “Companies with good ESG scores pollute as much as low-rated rivals”. Financial Times (31 July 2023). Available from <https://www.ft.com/content/b9582d62-cc6f-4b76-b0f9-5b37cf15dce4>.

³ The European Commission. COM/2021/391 final

⁴ “Sustainalytics can provide companies and issuers with an SPO plan that provides you with various credible independent reports to suit your ESG needs and business requirements.” Sustainalytics. Available from <https://www.sustainalytics.com/corporate-solutions/sustainable-finance-and-lending/second-party-opinions#plans>, viewed on 17 August 2023; “ISS Corporate Solutions’ (ICS) Second Party Opinion (“SPO”) services provide issuers with an independent assessment of their Green, Social and Sustainability-linked financing frameworks.” ISS Corporate Solutions. Available from <https://www.isscorporatesolutions.com/solutions/sustainable-finance/bond-issuers/>, viewed on 17 August 2023

Table 2 – IEEFA’s clarification seeking regarding Article 3

Text proposed by the Commission	Suggestions/Clarifications needed
<p>“regarding...ESG profile or characteristics or exposure to ESG risks or the impact on society and the environment”</p>	<p>Given the arbitrary nature of the concept of ESG and the breadth of topics relating to social and environmental impacts, the Regulation should provide further context /technical guide. For example, the proposed text seems to imply inclusion of not only commonly offered specialised ESG products (e.g. controversy assessments, carbon transition scores, taxonomy alignment screening governance scores), but also any “<i>score</i>” or “<i>opinion</i>” that forms rankings on a single matter or sub-matter (e.g. country corruption index, country happiness index, best employers ranking based on employee satisfaction and well-being). This would then become unnecessarily wide.</p> <p>In IEEFA’s view, the scope should cover specialised ESG products as they involve analyst output, and are often provided along with or form part of a holistic composite rating of ESG factors (typical perception of an ESG rating). The text should have sufficient clarifications to let these products and the typically perceived ESG rating stand out, particularly when a loosely defined “<i>ESG rating</i>” can span across both “<i>opinions</i>” produced by a variety of media outlets as well as statistical or algorithmic “<i>scores</i>” produced by specialised or pure software providers.</p>

Furthermore, IEEFA notes the following:

1. For the purpose of Article 3 (1), the Commission can consider outlining examples that are not considered as “*ESG ratings*” in the text. They may include the opinions served as the purpose of investment research or investment strategy defined by existing Commission Directives⁵, labels on financial products, etc.
2. The Commission may consider clarifying in the text that ESG ratings produced and published by non-profit organisations may be exempted in the scope when they are not for commercial use nor used in the construct of sustainable investments.

II. Organisational requirements and rating processes

IEEFA generally agrees with the principles of the text outlined in Title III Chapter 1 regarding organisational requirements, processes, documents concerning governance. Nevertheless, IEEFA notes in Table 3 its recommendations to strengthen the General Principles outlined in Article 14:

⁵ Commission Directive 2006/73/EC of 10 August 2006 implementing Directive 2004/39/EC of the European Parliament and of the Council as regards organisational requirements and operating conditions for investment firms and defined terms for the purposes of that Directive

Table 3 – IEEFA’s specific recommended additions regarding Article 14

Text	IEEFA’s recommendations
Paragraph 4	The rating providers should also adopt and implement written policies and procedures that ensure that a thorough analysis is well-presented and discussed in a rating determination process, and should set up corresponding internal appeal procedures. The providers should adhere to reviewing the applicable ESG ratings in the event of any material changes in the key rating input. Similar to IEEFA’s view on credit rating process ⁶ , ESG rating process should entail a robust and well-represented rating committee. Inclusion of independent sustainability expert(s) in the committee would enhance the committees’ capabilities and capacity when making the final decision on an ESG rating.
Paragraph 6	The rating providers should also ensure internal control mechanisms applies at all levels of the organisation. The providers’ decision-making procedures and organisational structures should, clearly and in a documented manner, specify reporting lines and allocate functions and responsibilities.
Paragraph 8	The Regulation should further specify the methodology review process (e.g. requiring review processes through internal and external consultation; requiring the provider to set up a separate methodology review function responsible for periodically reviewing its methodologies, models, key rating assumptions). Any changes to the methodology or internal guidelines should be independently validated and/or subject to public consultation. With regard to the principal that “ESG rating providers should use rating methodologies that are rigorous, systematic, objective, continuous”, historical experience, including back-testing, may become an important form of validation. The transition rates of ESG ratings may serve as a proxy ⁷ . Required public disclosure may include average one-year rating transition rate over a 3-year period. A relative stable ESG rating—one exhibiting minimal steep or drastic changes since its initial assignment—translates to a low transition rate and high accuracy rate, which may in turn signifies robustness and basis of the provider’s methodology.
Paragraph 9	The Regulation should further specify the requirements of monitoring and evaluation measures and processes (e.g. requiring the provider to set up a separate general internal review, quality control and/or rating policy function with clearly outlined role and responsibilities).
Paragraph 10	The Regulation should further specify the role and responsibilities of a permanent and effective oversight function. The function – separate from rating activities – should demonstrate some degree of authority, resources, expertise and access to all relevant information. The Commission should emphasise that it would be best practice to set up an administrative or supervisory board which demonstrates some degree of

⁶ IEEFA. Rating stability at risk from looming climate downgrades (21 August 2023). Available from <https://ieefa.org/resources/rating-stability-risk-looming-climate-downgrades>.

⁷ Securities and Exchange Board of India. Master Circular for ESG Rating Providers—Section 19.3.2. Disclosure of Average Rating Transition Rates (12 July 2023). Available from <https://www.sebi.gov.in/legal/master-circulars/jul-2023/master-circular-for-esg-rating-providers-erps-73856.html>.

	<p>independence and to which an executive oversight function reports. The providers should report on the details around this, including around relevant compensation policies.</p>
Paragraph 11	<p>IEEFA views that the text in this paragraph is relatively weak in the measures to ensure that the information used by ESG rating providers in assigning ESG ratings is of sufficient quality and from reliable sources, which is highly important to rating integrity. The Regulation should include some form of minimum requirements of quality and sufficiency of data to start an analysis, which aims to limit the (over)-use of estimates or proxy input data. While challenges of implementation are observed due to general limitations of ESG data, at least some phase-in initiatives should be considered, acting along with CSRD, because limited data itself is one root cause of the lack of consistency and comparability of ESG ratings⁸. Suggested required reliable and verifiable data sources may include but not limited to: minimum three years of key metrics externally assured, stakeholders' feedback/controversies, science-based evidence, widely recognised reference text, international standards, etc. The ESG rating providers should report on the key data sources used in each rating.</p> <p>Alternatively, the Regulation should at least require clear disclosure of whether and how the key data sources are of sufficiency and the extent that information is verified. The rating providers should formulate a clear policy in the event of a lack of reliable data or unsatisfactory data quality, including a clear disclosure of the rating limitations and an indication of scenarios where they would refrain from issuing a rating or withdraw an existing rating.</p>
Additional Paragraph Suggested	<p>The rating providers should also adopt and implement written policies and procedures relating to communication processes with rated entities, applicable for solicited and unsolicited ratings, respectively. This could help contextualise topics not limited to: information collection and verification, handling of non-public rated entities information, appeals by rated entities, conflicts of interest avoidance in particular for solicited ratings, etc. Also, the procedures should include an opportunity for the rated entity to draw attention of the rating provider to any factual errors, which aims to avoid wrongful damages inflicted by ESG ratings to rated entities.</p>

Furthermore, IEEFA notes the following observations and recommendations regarding Chapter 3 Independence and conflicts of interest:

1. Further to IEEFA's recommendations regarding Article 14 paragraph 10, IEEFA recommends the Commission should strengthen the requirements outlined in Article 23, in order to better safeguard the independence and accuracy of ratings. The Regulation should further contextualise the conditions of an oversight function and define its role and responsibilities. For best practices, the Regulation should require

⁸ Kimbrough, Michael D. and Wang, Xu (Frank) and Wei, Sijing and Zhang, Jiarui, Does Voluntary ESG Reporting Resolve Disagreement Among ESG Rating Agencies? (June 5, 2022). Available from <https://ssrn.com/abstract=4128503>.

the administrative or supervisory board of a rating provider to show some degree of independence as well as certain level of knowledge and expertise.

2. IEEFA notes that the text currently introduces no thresholds requirements relating to providers' ownership structure and controlling interests⁹. The Regulation should at minimum ensure that the rating providers disclose their up-to-date detailed ownership structure, material controlling interests, and material business relationships for stakeholders' access and assessments of any relating potential risks.
3. IEEFA notes the conflicts of interest arisen from compensation linkages are largely omitted in the text. Compensation of analysts or rating approvers linking to rating businesses, in particular revenues from rated entities, may cause biases and/or tendencies of lowered thoroughness of the analysis. The Regulation should require public disclose around the general nature of its compensation arrangements and allow authorities to request further details if needed.

III. Transparency /disclosure requirements

IEEFA regards the transparency requirements as one of the most pressing important areas in addressing the issues around lack of transparency and clarity in the ESG rating presentation. While the ongoing initiatives by ESMA to develop regulatory technical standards are appreciated, IEEFA strongly believes that minimum disclosure requirements to the public should be enlarged compared with those currently outlined in the text. Wider information available to the public is highly pivotal to tackle greenwashing and deception in rating description and methodologies, particularly when (1) a lot of end-users and stakeholders may not be direct subscribers; and (2) solicited ESG ratings – similar to credit ratings – show some characteristics of non-rivalry and non-excludability.

Therefore, IEEFA recommends that all elements outlined in Annex III section 2 should fall into minimum disclosure requirements to the public. IEEFA further suggests the following disclosure requirements to the public in addition to the current text:

1. ESG rating providers should make further disclosures to the public relating to:
 - a) the specific rating time horizon, including whether it is point-in-time as of release date or continue as of current date, in addition to indication of backward vs forward looking;
 - b) the rating scale (and sub-rating scale if applicable) and the description and definition – by quantitative and/or qualitative means – of the rating categories and key sub-categories assigned to each of the individual factors that are key determinants to a final rating;
 - c) their methodologies or policies in the event of insufficient data;
 - d) the scope of a rating methodology, especially for a specific industry or sectoral methodology;

⁹ D. Yongjun Tang, J. Yan, C. Yaqiong Yao, The determinants of ESG ratings: Rater ownership matters (6 June 2022). Available from https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3889395.

- e) the description/methodology of how a form of stakeholders/controversy assessments (if applicable) are considered in constructing an ESG rating.
2. ESG rating providers should also report regularly on:
 - a) detailed information around its legal structure and ownership;
 - b) the general nature of its compensation arrangements;
 - c) a description of its processes and procedures towards conclusion of a rating outcome;
 - d) any material changes to its methodologies, systems, resources or procedure;
 - e) a description of the internal control mechanisms ensuring quality of its ESG rating activities and any internal review outcome;
 - f) a description of its record-keeping policy;
 - g) differences in policies and procedures (if any) between the solicited and unsolicited ratings.
 3. For each ESG rating issued to the public, minimum disclosure to the public should include:
 - a) key rating rationale highlighting key factors and metrics considered;
 - b) any rating changes and the supporting rating rationale;
 - c) the scope of the rated entity's business activities
 - d) the principal rating methodology(ies) adopted specifying the version used;
 - e) key data and factual sources used (including methods to collect and verify data if applicable) and the key assumptions upon which a rating is based;
 - f) the date at which a rating was first released and when it was last updated;
 - g) reasons in the event of rating withdrawal

IEEFA notes that considering the broad offering of “*ESG ratings*”-like products, some additional and more stringent disclosure requirements may not be applicable to every product. Have said that, the Commission should aim to effectively tackle the main greenwashing concerns largely arisen from the mis-use¹⁰ and mis-interpretation of the composite ESG ratings¹¹ in funds and indexes with sustainable investing claims. The disclosure to the public – beyond subscribers – becomes more important when indirect users, including retail investors and pensioners, seek to align their sustainability objectives to their investments but are currently unable to do so.

Concluding remarks

Given the fast developing phase of the industry, IEEFA suggests the Commission should commit to a review clause sooner than the maximum of 5 years committed in the text (e.g. by mid 2026).

¹⁰ “An ESG Loophole Helps Drive Billions into Gulf Fossil Fuel Giants”. Bloomberg (11 July 2023). Available from <https://www.bloomberg.com/news/articles/2023-07-11/saudi-aramco-getting-cash-meant-for-sustainable-investment-reveals-esg-loophole>.

¹¹ Florian Berg and others, Aggregate Confusion: The Divergence of ESG Ratings, Review of Finance, Volume 26, Issue 6, November 2022, Pages 1315–1344, <https://doi.org/10.1093/rof/rfac033>

In addition to the recommendations outlined in the paper, IEEFA would like to emphasise its strong view that the Commission should address the gaps of the proposal when it comes in play with other legislative acts serving the overarching goals of the EU sustainable finance framework:

- This text should be harmonised with the requirements regarding external reviewer in the EU Green Bond Regulation and should close any loophole due to the limitations of the EU Green Bond Regulation as it currently stands.
- The European sustainability reporting standards (ESRS) under CSRD—if well implemented—should support minimum data sufficiency and quality requirements needed in this Regulation. ESRS should provide an indication of the core elements of a traditionally/currently perceived ESG rating (i.e. the required list of sustainability matters to form a rating), as well as the corresponding information and metrics to support an ESG rating assessment. This is, however, subject to a much broader mandatory requirement of a materiality assessment, supported with a well-defined rigorous materiality assessment processes, which is currently lacking in the ESRS adopted text as IEEFA noted in our response¹².
- In order to address the main greenwashing that lies around the mis-use and mis-interpretation of currently perceived ESG ratings, specific distributions and use of ESG ratings should be regulated—potentially through Sustainable Finance Disclosure Regulation and/or Benchmark Regulation. The use of impact+risk ratings and/or ratings that incorporate assessments of and appropriately weigh temperature alignments and EU taxonomy alignments should be mandated in circumstances such as Article 9 funds.

¹² Feedback from IEEFA to the European Commission on ESRS (6 July 2023). Available from https://ec.europa.eu/info/law/better-regulation/have-your-say/initiatives/13765-European-sustainability-reporting-standards-first-set/F3429617_en