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Key observations about the open EU consultation on the functioning of the EU ESG ratings market

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At a glance

- The European Commission has launched a consultation on the functioning of the ESG ratings market in the European Union and on the consideration of ESG factors in credit ratings. The consultation is open until 6 June 2022, accessible here: https://ec.europa.eu/info/consultations/finance-2022-esg-ratings_en
- The consultation is driven by the growing importance of ESG ratings and raises specific questions in relation to concerns identified in the study commissioned by the European Commission and published in January 2021.
- Concerns relate to transparency about methodologies and data sources; timeliness, accuracy and reliability of ESG ratings; biases in relation to size and location of rated companies; and potential conflicts of interest of rating providers. A 2021 consultation confirmed these concerns, in particular around comparability and reliability of ESG ratings.
- We recommend adopting a mandatory framework for disclosure of key assumptions, most sensitive methodology features and objectives of ESG ratings. Such framework shall reflect on different users of ESG ratings and their ability to access and use additional (meta-)information about ESG scores, and keep in mind that a competitive and diversified market should be characterised by differences amongst competing ESG rating providers, as long as market participants and users are able to appreciate the reasons behind such differences.

This Policy Brief is written in cooperation with **Climate & Company**, the Sustainable Finance Research Platform's partner organization for EU outreach.

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Background

The European Commission has launched a consultation on the functioning of the ESG ratings market in the European Union and on the consideration of ESG factors in credit ratings. The consultation is open until 6 June 2022.[1] It will directly inform the European Commission's impact assessment aimed at the scope and options for a possible EU intervention in addressing concerns in relation to ESG ratings

Against the backdrop of the ever-growing importance of ESG ratings, the consultation raises specific questions in relation to concerns identified in the study commissioned by the European Commission and published in January 2021.[2]

The identified concerns were related to transparency about methodologies and data sources; timeliness, accuracy and reliability of ESG ratings; biases in relation to size and location of rated companies; and potential conflicts of interest of rating[3] providers. A 2021 consultation confirmed these concerns, in particular around comparability and reliability of ESG ratings.[4]

On one hand, the consultation solicits responses by market participants and other users of ESG data, as well as data providers in relation to the concerns about the current functioning of the market for ESG ratings. On the other hand, the consultation "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."[5]

This short policy brief highlights the importance of ESG ratings and this consultation and would like to encourage readers to participate in the consultation. The authors highlight questions of particular importance from their (and a wider research) perspective and share their initial assessment for some of those, while proposing

[1] The consultation is accessible on the website of the European Commission (last access May 24, 2022. This also applies to all other online sources of this report, unless stated otherwise)

[2] European Commission (2022): Study on Sustainability Related Ratings, Data and Research (available online).

[3] See "Consultation Document", p.4 (available online).

[4] More information on the 2021 consultation can be found on the website of the European Commission

[5] Ibid., p.5

further steps and additional analysis for questions, which from the authors view cannot yet be answered in a satisfactory and comprehensive manner.

Why ESG ratings are so important from a research perspective and what research is already available

It is common market practice for investors, lenders, analysts and other market participants to draw on ESG ratings to better reflect sustainability considerations in their investment decisions. This has been confirmed by a number of research papers and surveys (see e.g., Dimson et al., 2020; Krueger et al., 2020).

From a more research focused perspective on sustainable finance, a broad range of research questions require robust, comparable and transparently derived ESG data. Where this research targets (for example) the effectiveness of various policy instruments in improving the ESG performance of companies or changing the aggregate ESG performance or orientation of sustainable finance instruments, the quality of ESG data in turn becomes relevant for researchers to be able to give good policy advice.

In relation to the concerns identified in the study commissioned by the European Commission and the previous consultation, a body of literature is available.

Earlier literature on ESG ratings reveals a substantial level of divergence between different rating providers' evaluation of the same firm (Dorfleitner et al., 2015; Chatterji et al. 2016). More recent work confirms that such differences in ratings persist (Berg et al. 2019, Billio et al., 2021), which can ultimately affect investors' financial performance, e.g. by influencing capital allocation (Krueger et al., 2020). Moreover, this disagreement can be observed in both, aggregate ESG ratings and raw data such as firm-level greenhouse gas emission. The magnitude of the disagreement seems to be related to the complexity of the raw data (Busch et al., 2022). Rating disagreement between ESG data providers makes it more difficult for researchers to appropriately address sustainable finance related research questions, especially when the number of ESG rating providers accessible is low. The EU Commission implemented the EU Taxonomy with the aim of harmonizing the definition and measurement of sustainability at the firm level. However, recent literature shows that the correlation between an asset's alignment with the EU Taxonomy's substantial contribution criteria on one hand and the corresponding environmental dimension of ESG ratings (E ratings) is weak to date (Dumrose et al., 2022).

In addition, academic research reveals that firms' ESG ratings are often subject to various biases. These biases can be created by endogenous and exogenous factors. For example, Drempetic et al. (2020) examines the effect firm size has on ratings and finds a positive relation between size and ESG ratings. This can be at least partially explained by the ability of larger firms to better gather and report the data required by rating providers. Furthermore, ESG ratings appear to be influenced by the geographic location of the rated firm and the firm's industry type (Gyönyörová et al., 2021).

Specific observations about an important sub-set of key questions raised in the consultation

With the limited time available to get this policy brief out in time to still facilitate the participation of others in the consultation (before its deadline on 6 June 2022) and to keep it sufficiently concise and "digestible", we decided not to provide a comprehensive response to the entire questionnaire, but to highlight key questions. In the following paragraphs, we are listing these key questions, provide short indicative responses and/or highlight the need for further and more in-depth analysis to answer important questions at the required level of scientific rigour.

Part I. Use of ESG ratings and dynamics of the market

This part is addressed to investors, asset managers and benchmark administrators.

1 What do you value and need most in ESG ratings: • transparency in data sourcing and methodologies, • timeliness, accuracy and reliability of ESG ratings, • final score of individual factors • aggregated score of all factors • rating report explaining the final score or aggregated score • specific information, please explain • data accompanying rating • other aspects

- While ESG ratings are very important to close the information gap between investors and investees, it is a well know phenomenon that individual ESG ratings differ. This is per se not a bad thing – it is basically a reflection of the circumstance that sustainability is a complex field. However, it is important that the users of ESG ratings (investors, asset managers) are aware of this fact. Then they can accordingly choose the rating provider that best matches their purpose / values / expectations.

2 Do you further believe that ESG research products have reached a sufficient level of maturity and comparability to allow users to fully understand the products they use?

- Regarding maturity, the answer is probably “yes”, but comparability remains a key challenge. While it cannot be the purpose that all ESG ratings (with their different foci on different ESG issues, etc.) yield the same result, it is key to understand why and in how far their differ (for example in terms of assumptions and methodologies). This question is thus important and the survey results will show whether this observation outlined above is already common sense or not.
- Transparency about the reasons behind these differences and limits to comparability (critical assumptions, difference in methodology, differences in objective and focus of the scores) will be important to better appreciate and then make best use of differing ratings.

Part II. Functioning of the ESG ratings market

3 To what degree do you consider that the following shortcomings / problems exist in the ESG ratings market, on a scale of from 1 to 10? Multiple choice answers as defined in the questionnaire: Lack of transparency on the operations of the providers; Lack of transparency on the methodologies used by the providers; • Lack of clear explanation of what individual ESG ratings measure; Lack of common definition of ESG ratings; • Variety of terminologies used for the same products; • Lack of comparability between the products offered; • Lack of reliability of the ratings; • Potential conflicts of interests; • Lack of supervision and enforcement over the functioning of this market; • Other

- It is important to understand what is actually being measured by the ratings: Is the focus on sustainability risks, for example, or is it about impact, i.e., a measurement of the contribution a company makes to achieving the SDGs.

4 Do you consider that there are any significant biases with the methodology used by the providers? Follow-up question: If you responded yes to the previous question, please specify the biases: • Biases based on the size of the company rated; • Biases based on the location of the company; • Other biases

- The term bias could be misleading in this context, as a bias has too much of a negative connotation. Different ratings have different aggregation methods and apply different weightings. This is the result of different ESG philosophies and/or a difference in the emphasis put on certain dimensions of ESG.
- But in terms of coverage, the available universe of ratings has a strong capital market bias and coverage of non-listed companies is more limited than that of large listed companies

5 To what degree do you consider that a low level of correlation between various types of ESG ratings can cause problems for your business and investment decision, as an investor or a rated company, on a scale from 1 (no problem) to 10 (significant problem)?

- This is another important question, since it will reveal to which extent the market believes that low correlations are an issue.
- The effect of strongly diverging scores for one and the same company could be that the incentive of improving ESG performance is reduced if the company cannot be sure how its improved performance would be reflected in a better score.
- Diverging scores also do not effectively fulfil their role of reducing information asymmetry, which would, ceteris paribus, tend to increase financing costs, in line with the literature on ESG disclosure and information asymmetry.
- In addition, companies may find it difficult to improve their sustainability performance if they feel that different ratings give completely different

weightings to different efforts. In the worst case, companies stop their attempts to improve.

6 How much do you consider each of the following to be an issue, on a scale from 1 (no issue) to 10 (very significant issue): Multiple choice answers as defined in the questionnaire: • There is a lack of transparency on the methodology and objectives of the respective ratings; • The providers do not communicate and disclose the relevant underlying information; • The providers use very different methodologies; • ESG ratings have different objectives (they assess different sustainability aspects); other;

- Lack of transparency and communication/disclosure of underlying information: In principle most ESG data providers make information about their methodologies available to investors, but they do often do so (at the required level of detail, beyond the online ESG brochures) only on demand. In addition, it is difficult to digest this information for smaller investors and market players with less in-house capacity to work with and interpret this information, not to mention dealing with this information across an entire range of ESG rating providers. The question here would be to make key assumptions, differences in methodologies and differences in the scores' objectives very transparent and easily accessible. If every data provider would communicate these in a harmonised manner, this could help reduce the effective lack of transparency and increase the usefulness of ratings
- Different methodologies and objectives: Providers use different methodologies, and this is first of all and in principle a sign of a competitive market (which is good for the consumer/user of this data) and/or reflects different objectives or weights given to different components of the aggregate ESG score. The key issue in terms of methodologies is the question of transparency and harmonisation:
  - Transparency (see point above): make key assumptions, key methodological features and differences in the scores' objectives very transparent and easily accessible.

- Harmonisation: the application of the taxonomy and other harmonised frameworks providing common sets of definitions

7 Do you consider that a variety of types of ESG ratings (assessing different sustainability aspects) is a positive or negative feature of the market?

- This question is again considered particularly pertinent, since this is what investors and asset managers actually should do. Instead of relying only on one ESG rating provider they should use and compare the data of at least two providers.
- Competition in the market is important; transparency and, where useful, harmonisation (e.g. via the taxonomy) could help market participants make best use of a range of different providers
- Differences in objectives and the focus of different ESG providers can be a reflection of their comparative advantage in assessing one dimension more and better than others; if communicated clearly, this is anormal and useful feature of a competitive and diversified market.

Part III. EU intervention

This section is focused on gathering "stakeholder views on the need and type of a possible intervention at EU level" in ESG rating markets.

8 Do you consider that there should be some minimum disclosure requirements in relation to methodologies used by ESG rating providers?

- Such minimum disclosure requirements are very important. Yet, many ESG rating provider do not disclose the details of their methods. As such, the rating approaches remain a black box. But a good understanding of the details is essential as only based on this investors and asset managers can decide which one best matches their requirements.
- On the other hand, disclosure of detailed information does probably not yet help less sophisticated users of ESG information or smaller financial institutions, which are not in the position to digest comprehensive methodological information. A mix of comprehensive and

structured/simplified disclosure of methodologies and the most sensitive assumptions (in line with the question below) would be ideal.

9 Do you consider that the providers should be using standardised templates for disclosing information on their methodology?

- This definitely would facilitate the comparability and appreciation of differences in assumptions, which in turn helps understanding differences at aggregate level.

Outlook and recommendations

We commend the European Commission for its effort to address concerns identified in relation to ESG ratings, against a backdrop of their ever-increasing relevance for market participants, regulators, and researchers. The approach the Commission has chosen, to build on a study (summarizing the available research) and consultation appears appropriate. Before any policy proposal can be tabled, some of the questions raised in this consultation will still need to be answered, not by the questionnaire alone, but for some to be complemented by mostly empirical analysis.

In the specific context of this consultation, we would highlight the following high-level recommendations

- Our most easy-to-act-upon recommendation is for stakeholders using or being affected by the use of ESG ratings to participate in the European Commission's consultation, which we are including again here for ease of reference: https://ec.europa.eu/info/consultations/finance-2022-esg-ratings_en
- Adopt a mandatory framework for disclosure of key assumptions, most sensitive methodology features and objectives of ESG ratings. In doing so:
    - reflect on different users of ESG ratings and their ability to access and use additional (meta-)information about ESG scores
    - keep in mind that a competitive and diversified market should be characterised by differences amongst competing ESG rating providers, as long as market participants and users are able to appreciate the reasons behind such differences.

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About the project

The Sustainable Finance Research Platform is a joint project between five German research institutions conducting research on different aspects of Sustainable Finance, e.g. sustainable investments, sustainability risks and chances, and sustainability reporting. With their independent research, the project partners aim to support stakeholders in politics, the financial sector, and the real economy in understanding and shaping the central role of capital markets in achieving a net-zero economy. The researchers involved answer social, political, and business-related questions, provide established and new research findings, and participate in political and public debate. They also want to establish sustainable finance as a topic in the German research landscape and secure connections with international institutes and processes.

More information can be found on the project's website wpsf.de/en/.

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