# German Sustainable Finance Advisory Committee

# Position Paper on an EU Regulation of ESG Rating Providers

Investors, banks and other financial market participants around the world, as well as companies themselves, are increasingly using sustainability or ESG ratings and scores to make investment decisions, carry out financial transactions, and create benchmarks and comparison groups. For many years now, such ratings and scores have been one of the most important sources of information for making sustainable financial decisions.

As sustainability has increasingly found its way into the finance mainstream in recent years, sustainability ratings have been subject to growing criticism – both from practitioners, including the rated companies themselves and financial market participants who use the data for investment decisions and other purposes, as well as from researchers (see the rising number of academic publications and the academic debate on the subject). In this debate, ESG ratings are frequently compared with well-known and established corporate credit ratings, without taking into account the historical differences, the difficulties of assessing information that is not only quantitative but also strongly qualitative in nature, or differences in payment practices and business models.

Key points of criticism include (a) the stark differences in rating results that sometimes occur and the low level of comparability of ESG ratings, (b) the insufficient quality of the methodologies used, and (c) the need for minimum standards. Other important issues include a lack of transparency on the part of ESG rating providers regarding their methodologies and processes, as well as potential conflicts of interest, for example if ESG rating agencies sell data or consultancy services to the companies they rate.

The German government's Sustainable Finance Advisory Committee (SFB) considers the analysis and regulation of ESG ratings to be a very important goal during the current legislative term. In the context of its "Reporting, Reviewing, Quantifying" working group, the SFB has identified this subject as a priority for 2023, especially against the background of the expected mid-June publication by the European Commission of draft legislation on ESG ratings.

To draft the present position paper, the working group carried out various activities in April and May 2023, including (a) five extensive interviews with ESG rating providers (Imug, ISS ESG, MSCI, Sustainalytics and S&P), (b) an internal SFB survey on the key topics mentioned above, (c) several rounds of discussions within the working group, and (d) a final round of comments and consultations across the wider SFB. The present paper summarises the opinions within the SFB on the future regulation of ESG rating providers in the EU. All the topics were discussed in depth. In most cases, a majority opinion was formed. In other cases, there were various divergent opinions and no clear majority coalesced. These differences of opinion are described explicitly in this paper.

This paper also contains an appendix with selected sources that discuss the subject of ESG ratings and associated challenges in greater detail.

Contents:

# 1 Regulation of ESG rating agencies

## *1.1 General position on the subject of regulation*

The SFB recommends that ESG rating agencies in the EU should generally be regulated. Purposes of regulation:

- To help ensure the quality of ESG ratings
- To ensure that market participants have access to clear and reliable information
- To prevent conflicts of interest on the part of ESG rating providers

As part of these regulatory efforts, the SFB considers it desirable to establish common terminology in the area of ESG ratings. This applies to the core terms used (including “ratings”, “scores”, “assessments”, “evaluation”) and to the objectives of the individual ratings (for example the extent to which more emphasis is placed on financial risk, impact, or the issue of double materiality) and the definitions of these objectives.

## *1.2 Scope of regulation*

The SFB recommends that all providers of ESG ratings and scores who offer or market their products and services within the EU should be subject to regulation, regardless of where their headquarters or individual business units are located. The size of the providers (e.g. number of employees, balance sheet total, market coverage) should also be irrelevant. It is important that the rules apply not only to the providers themselves, but also to subsidiaries within the group. Otherwise, there is the risk of circumvention efforts similar to those observed on the credit rating market.

Regulating ESG data providers and their products and services is considered to be just as important as regulating pure ESG rating agencies. Due to the EU’s sustainability rules (e.g. the EU taxonomy, the SFDR, and Solvency II for insurance companies), ESG data is increasingly essential for investors. To obtain reliable data and achieve a level of standardisation and comparability, the rules for pure data providers should be subject to certain methodological requirements.

Providers of SPOs (Second Party Opinions for green/sustainable securities) should be regulated in the same way, possibly under the EU Green Bond Standard, as already envisaged by the EU.

The SFB also discussed whether the prospective rules should apply to investors who produce ESG ratings or assessments themselves and use them in funds and mandates that they market within the EU. The reasoning behind this is that such ratings and assessments also feature ESG ratings of companies. There were divergent opinions on this subject within the SFB (and among the interviewed ESG rating providers).

# 2 ESG rating methodologies and data

## *2.1 Differences in rating results and methodologies*

The SFB recommends that there should be no standardisation in the form of prescribed ESG rating methodologies. The prevalent opinion within the SFB and among the interviewed ESG rating providers is that it is only natural that different methodologies (can) produce differing ratings, since different approaches are used as a basis (e.g. impact vs. financial materiality) and different topics and individual aspects are analysed with different weightings.
When choosing a provider or gathering ESG information about companies, financial market participants and other users of ESG ratings should therefore familiarise themselves thoroughly with the methodologies used (which must be

made transparent, see section 2.3). Moreover, it is considered too early to codify these aspects, as the area of sustainable finance and sustainability reporting is still evolving dynamically, as is the market of ESG rating providers and other stakeholders.

However, the SFB recommends that clear minimum standards be set for all regulated parties. These should be consistent with quality standards for sustainability research and international frameworks (e.g. ILO core labour standards and the Paris Agreement) and should be based on science (e.g. SBTi) to ensure a certain (minimum) quality of ESG ratings. One option would be to make it obligatory to set out these parameters as standard information preceding the ratings (in the form of a short summary).

Further key information that should be included in ESG rating reports:

- Approach/philosophy of the methodology used
- Past trends/multi-year overview of scores
- Sector allocation and ranking
- Sub-scores for ESG topics and sub-topics
- Primary external data sources used and handling of data gaps

It also seems very important to require ESG rating agencies to update their rating results regularly, or at least to transparently disclose how recent their information is, along with the date of the rating.

## *2.2 Use of ESG data*

The SFB recommends the development of minimum standards for the data sources used. It is true that the availability of ESG data in Europe is improving (see availability of EU taxonomy data for carbon-intensive sectors), and that future ESG-related standards (the CSRD in the EU, the ISSB internationally and also sector-specific standards) can be expected to accelerate this trend significantly in the coming years. However, until there is near-complete and standardised ESG data availability, it is important to set specific minimum standards for the data sources used. The following aspects are considered to be important in this context:

- In Europe, company data published mainly in connection with EU legislation, such as the CSRD or CSDDD in the future, should be a key source.

- Some of the interviewed ESG rating agencies use estimates (e.g. sector averages) to fill data gaps if no published company data is available. Others view missing data as a lack of transparency on the part of the company. Here too, it should at least be made clear which approach the rating provider has taken.

- It is a mark of quality if ESG data has been reviewed by public accountants. However, very few of the interviewed ESG rating providers take this into account in their ratings. This could be included in future ESG ratings as a separate criterion or used as a positive criterion when assessing ESG data.

## *2.3 Transparency regarding ESG rating methodologies*

The SFB recommends that ESG rating agencies should be required to make their methodologies publicly accessible, to the extent possible. Information that the SFB considers especially important:

- Philosophy underpinning the ESG rating (impact, performance, etc.)
- Description of the methodology for all ESG products (ratings, scores, data sets, etc.)
- Methodology for determining ratings/scores (overall score, E/S/G distribution, subject areas, individual indicators), including weightings
- Policy for dealing with missing company data
- Information on the data sources used (including the date of publication of the data)

Further information on ESG rating methodologies that the SFB considers to be important:

- Reasons for the weightings chosen
- Detailed description of individual data points
- Requirements for best practice thresholds
- Proactive, publicly accessible and timely information on any changes in methodology
- Explanation of sector classifications

During the interviews, ESG rating providers largely agreed that transparency regarding the methods used is important to ensure that clients and companies understand how a rating is structured and how the results have been obtained.

However, the providers also agreed that not all details should be made entirely public, as this would constitute the disclosure of commercial/industry secrets.

## 3 Rating processes and dialogue with companies

### *3.1 Minimum standards and transparency regarding rating processes*

The SFB recommends that ESG rating providers should be required to define and document internal quality assurance processes. These processes should be transparent and publicly accessible. The SFB considers the following information to be very important:

- Changes in rating methodology
- Quality control and conflict resolution
- Existence and frequency of dialogue with companies
- Date of ratings and frequency of updates
- Outsourcing of data collection
- Education and training of analysts
- General overview of rating processes

### *3.2 Dialogue with companies and complaint management*

The SFB recommends that ESG rating providers should be required to obtain feedback from the companies before publishing their ratings and scores. Companies should regularly be given the opportunity to comment on their ratings (at least once a year).

Moreover, rating providers should be required to put in place a publicly accessible complaint management system featuring escalation processes and a clearly designated contact for complaints.

The introduction of company feedback increases the quality of ratings, because missing data can be added and incorrect data rectified. In addition, companies are always kept informed of existing ratings, and questions about the methodology and rating or even misunderstandings can be resolved. Overall, this could generally result in higher acceptance of ESG ratings.

### *3.3 Inclusion of stakeholder opinions*

ESG rating providers assess the social impacts of business activities. The SFB intensively discussed the extent to which rating providers should be required to involve stakeholders (i.e. employees, consumers and local authorities in addition to the companies).

The SFB recommends regular, documented consultations with the affected stakeholder groups (e.g. through their involvement in committees, publicly accessible market consultations, or even the opportunity to view and comment on ratings). Although this would involve additional work, it could also improve the quality of rating results and, not least, increase general stakeholder acceptance.

## 4 Independence and conflicts of interest

### *4.1 “Issuer pays” vs. “investor pays” business models*

The SFB discussed whether the dominant “investor pays” model (banks, investors and other financial clients pay for ESG rating data) should be replaced with an “issuer pays” model (the rated companies pay for the ESG rating). There was no clear majority either for or against this.

For the interviewed ESG rating providers, an “issuer pays” model would be more lucrative, and some providers already offer such solutions to interested companies. However, large-scale implementation of the “issuer pays” principle does not appear to be feasible in the medium term, especially because, in contrast to credit ratings, the size of the rated universe (i.e. the number of companies rated by the respective rating provider) is much more important than individual ratings, for example in order to establish benchmark ratings.

Only few companies currently seem willing to pay for an ESG rating. Moreover, the “investor pays” model ensures greater independence from the rated companies (and thus reduces potential conflicts of interest).

### 4.2 Marketing of products to rated companies

The SFB recommends the regulation of other consultancy and marketing activities that ESG rating agencies provide to companies. This is due to potential conflicts of interest, which the SFB views as a crucial issue.

In particular, the SFB is broadly opposed to paid consultancy services for rated companies (e.g. with the aim of improving scores). A majority within the SFB favours the strict regulation of such consultancy activities. However, ESG rating agencies should be permitted to offer other products or services (e.g. benchmark products, SPOs, and supply chain databases).

### 4.3 Handling of conflicts of interest

To further prevent conflicts of interest, the SFB recommends that rating providers should be required to set up "Chinese walls" in the form of suitable organisational structures or processes when offering paid products or services to companies.

However, a majority of the SFB considers it a step too far to require companies to externalise these "Chinese walls" by creating separate legal business entities, even though scientific studies in particular support this approach.

In any case, ESG rating providers should definitely be required to disclose their policy for handling conflicts of interest.

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*Any questions about this position paper can be addressed to the SFB's secretariat via email: SFB-Geschaeftsstelle@bmf.bund.de.*

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## 5 Appendix

*The following publications deal with the subject of ESG ratings in detail:*


- Berg, Fabisiks and Sautner (2021) - https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3722087

- Berg, Florian and Fabisik, Kornelia and Sautner, Zacharias, Is History Repeating Itself? The (Un)Predictable Past of ESG Ratings (August 24, 2021). European Corporate Governance Institute – Finance Working Paper 708/2020, available at SSRN: https://ssrn.com/abstract=3722087

- Berg, Florian; Kölbel, Julian; Rigobon, Roberto (2019): Aggregate Confusion: The Divergence of ESG Ratings. In: SSRN Journal 68 (6), p. 2435. DOI: 10.2139/ssrn.3438533

- Berg, Kölbel and Rigobon (2019) - https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3438533

- Billio, Monica; Costola, Michele; Hristova, Iva; Latino, Carmelo; Pelizzon, Loriana (2021): Inside the ESG ratings: (Dis)agreement and performance. In: Corp Soc Responsib Environ Manag 28 (5), pp. 1426–1445. DOI: 10.1002/csr.2177

- Busch, Timo; Johnson, Matthew; Pioch, Thomas (2022): Corporate carbon performance data: Quo vadis? In: Journal of Industrial Ecology 26 (1), pp. 350–363. DOI: 10.1111/jiec.13008

- Chatterji, Aaron K.; Durand, Rodolphe; Levine, David I.; Touboul, Samuel (2016): Do ratings of firms converge? Implications for managers, investors and strategy researchers. In: Strat. Mgmt. J. 37 (8), pp. 1597–1614. DOI: 10.1002/smj.2407

- Dimson, Elroy; Marsh, Paul; Staunton, Mike (2020): Divergent ESG Ratings. In: JPM 47 (1), pp. 75–87. DOI: 10.3905/jpm.2020.1.175

- Dorfleitner, Gregor; Halbritter, Gerhard; Nguyen, Mai (2015): Measuring the level and risk of corporate responsibility – An empirical comparison of different ESG rating approaches. In: J Asset Manag 16 (7), pp. 450–466. DOI: 10.1057/jam.2015.31

- Drempetic, Samuel; Klein, Christian; Zwergel, Bernhard (2020): The Influence of Firm Size on the ESG Score: Corporate Sustainability Ratings Under Review. In: J Bus Ethics 167 (2), pp. 333–360. DOI: 10.1007/s10551-019-04164-1

- Dumrose, Maurice; Rink, Sebastian; Eckert, Julia (2022): Disaggregating confusion? The EU Taxonomy and its relation to ESG rating. In: Finance Research Letters 48 (6545), p. 102928. DOI: 10.1016/j.frl.2022.102928

- Fabisik, Kornelia and Schäfer, Larissa and Steffen, Sascha, Do Debt Investors Care about ESG Ratings? (February 11, 2022). Available at SSRN: https://ssrn.com/abstract=4032923

- Gibson, Rajna; Krueger, Philipp; Riand, Nadine; Schmidt, Peter Steffen (2019): ESG Rating Disagreement and Stock Returns. In: SSRN Journal 18 (3), p. 875. DOI: 10.2139/ssrn.3433728

- Gyönyörová, Lucie; Stachoň, Martin; Stašek, Daniel (2021): ESG ratings: relevant information or misleading clue? Evidence from the S&P Global 1200. In: Journal of Sustainable Finance & Investment 44 (4), pp. 1–35. DOI: 10.1080/20430795.2021.1922062

- Li, Lou and Zhang (2022) - https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4190204

- Rzeźnik, Aleksandra and Hanley, Kathleen Weiss and Pelizzon, Loriana, Investor Reliance on ESG Ratings and Stock Price Performance (July 27, 2022). SAFE Working Paper No. 310, Available at SSRN: https://ssrn.com/abstract=3801703

- SustainAbility (2023) - https://www.sustainability.com/thinking/rate-the-raters-2023/