German Banking Industry Committee

Die Deutsche Kreditwirtschaft

Comments

on the Commission proposal for a Regulation on ESG rating activities

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Contact:
Thomas Nicht
Telephone: +49 30 2021-1609
E-mail: t.nicht@bvr.de

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Coordinator:
National Association of German Cooperative Banks
Schellingstraße 4 | 10785 Berlin | Germany
Telephone: +49 30 2021-0
Telefax: +49 30 2021-1900
www.die-deutsche-kreditwirtschaft.de

Executive summary

The Regulation, as proposed, is a step in the right direction in regulating the ESG ratings market and improve the quality of ESG ratings. However, some uncertainties and issues remain, especially with regards to the Regulation's scope and in the context of unsolicited ratings. It is welcome that more transparency and reliability is being brought into the procedures regarding methodologies. The proposal lacks, most of all, explicit requirements to facilitate individual engagement and feedback opportunities between ESG rating providers and rated entities, and an obligation for rating providers to publicly consult on changes to methodologies.

General remarks

We welcome the adoption by the European Commission of a proposal for a Regulation to improve the transparency and integrity of ESG rating activities. The use of ESG ratings will increase in the future, notably in the context of second party opinions and the issuance of green bonds. The Regulation is a step in the right direction, especially from the point of view of rated entities, but should be readjusted in some areas to become more effective. In particular, we welcome the Commission's proposed focus on commercial ESG rating activities, thus exempting purely internal scorings and evaluations.

We note that the Commission decided to regulate ESG rating activities and providers in a similar way to credit rating agencies. However, the purpose of ESG ratings is different to credit ratings and a regulation of ESG rating activities needs to reflect specific requirements. Since ESG ratings are mostly not solicited by the rated entities, there is no incentive for the rating providers to engage with those entities, instead solely relying on publicly available information, lacking necessary insight into a rated entity's arrangements and activities to fairly and thoroughly assess its ESG risks and impacts. This is reinforced by the fact that the production of ESG ratings is subject to limited competition and prone to economies of scale, thus favouring quantity before quality, and often lacking in-depth analysis of a rated entity. Some rating agencies outright refuse to cooperate with the rated entities.

In contrast to the Regulation on credit rating agencies (Regulation (EC) No 1060/2009 – CRAR) the proposal is silent on certain aspects of unsolicited ratings. The issues that CRAR wants to address (see, for example, Article 10(5) CRAR) apply also to unsolicited ESG ratings. We therefore propose to include the relevant CRAR provisions in the Regulation for ESG rating activities in a comparable way.

The handling of so-called "controversies" is a specific and more recent topic that increasingly gains importance. Even a single controversy can have an immense impact on how investors evaluate a rated entity. From the rated entity's perspective, it is therefore important that controversy reports are produced with the highest professional standards and rated entities have the possibility to interact with the provider of these reports to ensure a fair and informed evaluation. The proposal does not elaborate on this aspect.

Finally, a civil liability clause (akin to Article 35a CRAR) is missing in the proposal. The rationale for including a civil liability clause (as provided in CRAR, recital 32) is the significant impact credit ratings have on investment decisions and on the image and financial attractiveness of issuers. The same applies to ESG ratings.

In the following, we would like to further comment on selected provisions.

1. Scope (Article 2)

We welcome that the Commission distinguishes between ESG ratings that are made available for commercial purposes and ESG ratings that are developed for internal use. Financial institutions use their own models and do not provide ESG ratings commercially to other companies. Therefore, the main problem that this initiative aims to address (i.e. information asymmetry between providers and users of ESG ratings) does not arise in their case. Therefore, Article 2(2)(b) rightly excludes ESG ratings used for internal purposes or for the provision of internal financial services and products from the scope of the Regulation.

However, there are constellations, such as within a group of affiliated institutions, where ESG ratings are not produced by a credit institution itself, but by a specialised company belonging to the same group. Here, too, the ESG ratings are not made available to the general public, but serve the internal purposes of the companies belonging to the group. Therefore, such constellations should also be excluded from the scope. The same should be true if this specialised company provides a rating model which these banks use to prepare the ESG ratings for internal purposes themselves.

2. ESG Data Providers (Article 2)

We welcome the initial focus of this Regulation on ESG rating providers. Alongside them, raw ESG data also plays an increasingly important role within the market, for example with regards to climate risk management, reporting or in the design and structuring of ESG products. This necessitates that such data is transparent, reliable and comparable. Our members however report a lack in transparency on the sources, approximation, estimation or validation of raw ESG data as well as occasional provision of wrong data. While the CSRD and its implementing ESR will enhance the availability and reliability of ESG data for EU issuers, significant data gaps will remain, especially with regards to non-EU corporates.
Consequently, providers of raw ESG data should be regulated – however, this should be achieved either through a separate initiative or at a later stage after the details of the ESG Ratings Regulation were finalised. Regulating providers of raw ESG data does in our view necessitate additional impact assessments and measures ensuring proportionality. In contrast to many ESG rating providers, providers of raw ESG data are often smaller, innovative start-ups offering specialised tailor-made services for specific topics, such as nature-related data. Simply expanding the scope of the ESG Ratings Regulation might thus not be appropriate. In regulating providers of raw ESG data, particular emphasis should be placed on the transparency with regards to data sources, data collection processes, processes to address missing data and methodologies used for estimation, as well as data quality controls.

3. Clarifications on the Regulation's scope (Article 3)

We welcome the proposed focus of the ESG Ratings Regulation on commercial ESG ratings and the corresponding clarification that internally developed ESG scores or ratings do fall into its scope. Some services offered by banks do however not exactly fit the definitions and limitations set out by the Regulation, particularly investment research, recommendations and opinions. We are concerned, that the broad definition of ESG ratings and the suggested scope of the Regulation may encompass those activities, even though the Regulation does not intend to do so. Similarly, the EU's Credit

Rating Regulation carves these services out explicitly since they do not constitute credit ratings in the sense of that Regulation. In our view, the ESG Ratings Regulation should include a similar limitation in the ESG-context and thus clarify its definition of ESG ratings in Article 3(1) in the following manner:

"For the purpose of paragraph (1), the following shall not constitute an ESG rating:

(a) "information recommending or suggesting an investment strategy" or "investment recommendations" and within the meaning of Article 3 paragraph 1 Nr. 34 and 35 of Regulation (EU) 596/2014;

(b) ESG-related investment research as defined in Article 36 paragraph 1 of Delegated Regulation 2017/565 and other forms of general ESG-related recommendations, relating to transactions in financial instruments or to financial obligations; or

(c) opinions about the sustainability profile of a financial instrument or a financial obligation; or

(d) information provided in the context of the provision of investment advice (Article 4 paragraph 4 of Directive (EU) 2014/65) and portfolio management (Article 4 paragraph 8 Directive (EU) 2014/65."

In fact, such services are already regulated under by MiFID and/or the SFDR.

4. Third Country Regime (Articles 9 to 12)

Furthermore, we are concerned with the Commission's intended use of the Benchmark Regulations existing third country regime to allow third country rating providers to offer their ratings in the EU (through either equivalence, recognition or endorsement). Considering that many banks use ESG rating produced by non-EU rating providers, the proper functioning of this third country regime is vital.
The Benchmark Regulation's third country regime has been very controversial. In fact, it has not yet gone live, because it is not expected to function properly. Currently, the Benchmark Regulation provides a transition period until the end of 2023, which allows third country benchmark providers to continue providing their benchmarks in the EU without adhering to this regime. It is expected, that the Commission will extend said transition period to the end of 2025 in the near future. Post-Brexit, the UK also inherited this third country regime, has already extended it until end-2025 and will likely overhaul the system before the end of the transition period. The ESG Ratings Regulation should thus only reference a new and revised third country regime from the Benchmark Regulation.

5. Separation of business activities (Articles 14 and 15):

While we note that certain firms such as data providers or credit rating agencies which also provide ESG ratings do so via separate business units, concerns prevail that separation could pose a risk to the availability of certain other services such as (ESG) benchmark activities. **We would like to urge the co-legislators when considering the proposal not to hamper such activities.**

In fact, ESMA's advice on transparency encourages the increasing integration of ESG data into credit ratings. Consequently, the proposed separation of credit and ESG rating activities might not be useful. Instead, new governance structures should ensure that credit rating agencies can use and include ESG aspects in their ratings and vice versa. This provides simultaneous growth and leverages synergies of ratings and rating providers.

6. **Obligation of rating providers to ensure the necessary competences of rating analysts (Article 16):**

The proposal applies the concept of double materiality to rating products. One dimension of the double materiality concept requires analysts to be competent in assessing material financial risk to the rated entity (see recital 21). There is a general perception that ESG rating analysts are not sufficiently trained in the assessment of how financial risk may materialise in the underlying business such as, in our case, the banking business in its different facets. The requirements as foreseen in Article 16(1) where rating providers must ensure that analysts have the knowledge and experience that is necessary for the performance of the duties and tasks assigned are welcome but too vague. **Rating providers should additionally be obliged to ensure that analysts are trained to appropriately consider the specifics of the underlying business.**

7. **Complaints-handling mechanism (Article 18):**

It is to be supported that the proposal establishes an independent complaints procedure under Article 18. Given the growing importance ESG ratings have for investment decisions, it is key that rated entities have the possibility that their complaints are treated in a professional, independent, and timely manner. The time limits for this procedure should, however, be more precisely defined. The wording "timely and fair manner" and "reasonable period of time" in article 18(2)(b) leave too much room for interpretation.

8. **Disclosures in relation to methodologies (Articles 21, 22, Annex III 1,2 Draft-R):**

The introduction of formal requirements on methodologies and changes to methodologies is to be welcomed. Issues included not communicating to rated entities the availability of rating methodologies and changes thereof, including not consulting publicly on such changes. This seems to be addressed in Article 22 i.c.w. Annex III 1(a) and 2(a). If changes to a methodology lead to a downgrade of a rated entity, there has usually not been provided an explanation, or the possibility to provide feedback. This seems to be covered by Annex III 2(e), at least partially.

However, the requirements in relation to the disclosure of methodologies need to go further. **The Regulation should explicitly oblige providers to (publicly) consult on new methodologies or changes to an existing methodology.** Disclosure in relation to methodologies needs to ensure that, when a rating or update to a rating is being published, it cannot happen that (side) aspects, given the known methodology, are being unexpectedly over-emphasised.

9. Individual vs. platform-based engagement policies (Article 22 i.c.w. Annex III 2(c) and (e)):

A feature of the disclosure in relation to methodologies and the rating process needs to be the obligation for providers to allow for individual engagement with rated entities. Engagement with rated entities can take place via individual contact or platform-based feedback. Engagement needs to be meaningful but platform-based feedback often remains unanswered and leads nowhere. Reliable individual contact is preferable, even though also in this case, concerns prevail when a provider remains rather evasive or provides contradictory responses.

Individual engagement has many advantages:

- It could more easily clarify false categorisation of rated entities, where such entities which belong to the same peer group are categorised differently, and leading for the falsely categorised entity to questions that cannot be answered, or areas are being analysed where the entity is not active.
- Specifics of a business model could be explained better, e.g., the risk exposure (or the material financial risk of the rated entity as one dimension of the double materiality, see recital 21) in case of on-lending, where promotional banks provide lending to the real economy via commercial banks.
- Local legal requirements could be explained which may prevent public banks such as promotional banks and municipality funding agencies from engaging in certain activities.
- Rated entities usually only get to see the final rating report. Instead, a new rating report should be made available to the rated entity in advance and the rated entity should have the opportunity to comment on it.

To improve communication between rating provider and rated entities and facilitate individual engagement there should be a reliable and dedicated contact person on the side of the ESG rating provider. The provision of a communication portal is not sufficient since it requires proactivity from the rated entity and contact attempts often go answered.

Article 22 should therefore be extended in the following way:

To facilitate efficient disclosures in relation to methodologies and provide a meaningful feedback opportunity in relation to rating products, rating providers shall allow as default individual engagement with rated entities, including through reliable contact persons.

10. Conflicts of interest management (Articles 23 and 24):

Conflicts of interests need to be appropriately managed in the context of providing ESG ratings on an unsolicited basis in comparison to those provided on a solicited basis. It needs to be ensured that ESG ratings are based on fair, reasonable, transparent, and non-discriminatory treatment of the rated entities and users and are of the highest possible quality. **The requirements of Articles 23 and 24 seem to address this, notably Article 23(2), and are to be welcomed.**