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European Union releases proposal to regulate transparency and integrity of ESG rating activities

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Introduction

As sustainable investing and lending gain traction, environmental, social and governance (ESG) ratings and scores provided by ESG rating providers are becoming increasingly important to investors, lenders and issuers. An ESG rating provider is marketed as providing opinions on how a company is performing in relation to ESG factors. Green bonds and sustainable linked instruments provide examples of how ESG ratings may serve as an input in relation to the economic outcome, with, for example, sustainability-linked loans and bonds that see their coupon or interest rate increase or decrease if the ESG rating of the borrower or issuer falls below a predetermined threshold. ESG ratings are also used by asset managers that use ESG ratings to construct their portfolios. ESG rating providers are further expected to continue to grow in the coming years, in light of the overall and global ESG trend, and in particular due to the new requirements imposed on financial institutions and market participants by the European Union's sustainable finance legislation, such as:

- the EU Taxonomy Regulation;
- the CSRD; and
- the Sustainable Finance Disclosure Regulation.

This will most likely lead to an increased demand for ESG rating providers.

However, according to the European Commission, ESG rating providers and the ESG rating market suffer from deficiencies and are not functioning properly, mainly due to the lack of transparency in respect of the features of ESG ratings, the providers' methodologies and data sources, as well as the lack of clarity on how ESG rating providers operate.[(1)] In the light of this, on 13 June 2023, the European Commission proposed a new regulation on ESG ratings, namely a proposal for a regulation of the European Parliament and of the Council on the transparency and integrity of ESG rating activities.

This article provides a description of the proposed regulation and addresses its main features.

Key features

The proposed regulation aims to establish a coherent regulatory regime within the European Union to enhance the integrity, accountability, good governance and independence of ESG rating activities, thereby contributing to the transparency and quality of ESG ratings and also to ensuring investor protection and prevent green and social washing.

Pursuant to the proposed regulation, legal entities wishing to provide ESG rating activities in the European Union must apply for authorisation and will be subject to supervision of its ESG rating activities. A requirement is, however, that the ESG rating provider make their reports publicly available. The European Securities and Markets Authority (ESMA) is proposed to be empowered to carry out the supervision. ESMA will:

- develop regulatory technical standards to specify the information to be submitted as part of the authorisation process; and
- further establish and maintain a publicly available register containing information on all authorised ESG rating providers.

The European Commission is also given the authorisation to adopt delegated and implementing acts.

The proposed regulation imposes a number of organisational requirements on ESG rating providers. The ESG rating provider must, among other things:

- adopt rules and procedures that ensure that the ESG rating is provided in accordance with the proposed regulation and ensure that independence is retained in respect of their rating activities;
- implement policies and procedures for ensuring that their ESG ratings are based on a thorough analysis of relevant information;
- use rating methodologies for the ratings that are rigorous, systematic, objective and capable of validation. These rating methodologies shall be applied continuously;
- review the rating methodologies at least annually;
- disclose on their website the methodologies, models and key rating assumptions used in their ESG rating activities; and
- refrain from providing certain services, such as issuing and selling credit ratings, investment activities (including advisory services to investors), auditing, banking and insurance.

ESG rating providers must also explicitly state in their ESG statement that the rating is their own opinion, as well as have complaint handling mechanisms in place.

Where ESMA finds that an ESG rating provider is not complying with its obligations under the proposed regulation, ESMA is entitled to take the following supervisory measures, among others:

- revoke authorisation;
- temporarily prohibit the ESG rating provider from providing its services;
- require the ESG provider to cease with a potential infringement; and
- impose fines in the maximum amount of 10% of the total annual net turnover of the ESG rating provider.

Comment

ESG ratings are a broadly homogeneous set of products offered by companies that aim to provide an objective, data-driven third-party assessment of ESG aspects. There is no official definition of ESG ratings in European law. However, based on the definitions used by some of the ESG rating providers, ESG ratings can be divided into two main categories, as described below.

ESG risk ratings
These are the most common form of rating, measuring the exposure of companies to ESG risks and how the risks are managed. Examples of rating providers providing such ratings include:

- MSCI (resilience to long-term, industry material ESG risks);
- sustainalytics (the exposure and management of material ESG issues affecting a company´s enterprise value);
- S&P (exposure of an entity's operations to ESG risks and opportunities); and
- FTSE Russell (exposure to, and management of, ESG issues).

ESG impact ratings
These ratings measure the impact of entities on ESG factors. This category would include ratings from providers such as:

- Refinitiv (relative ESG performance, commitment and effectiveness);
- Moodys (willingness and capacity to integrate sustainability criteria);
- ECPI (sustainability measure);
- Sensefolio (ESG involvement); and
- Inrate (environmental and social impacts).

In line with the lack of a legal definition of what constitutes "ESG ratings", there is no clear understanding of the criteria by which a provider can qualify as an ESG rating provider. As described above, the ESG rating market has also been criticised for:

- its lack of objectivity;
- the methodologies and data sources used by providers; and
- the lack of clarity on how ESG rating providers operate.

The lack of a regulatory framework in this area risks limiting the benefits of these ESG ratings and the path towards a greener society. The lack of definitions, together with transparency issues, could ultimately hamper the transition to a more sustainable financial system and lead to greenwashing. Against this background, the proposed regulation is a welcome product of European legislation.

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Endnotes

(1) Proposal for a regulation of the European Parliament and of the Council on the transparency and integrity of ESG rating activities (the proposed regulation), page 1 ("Context of the proposal").