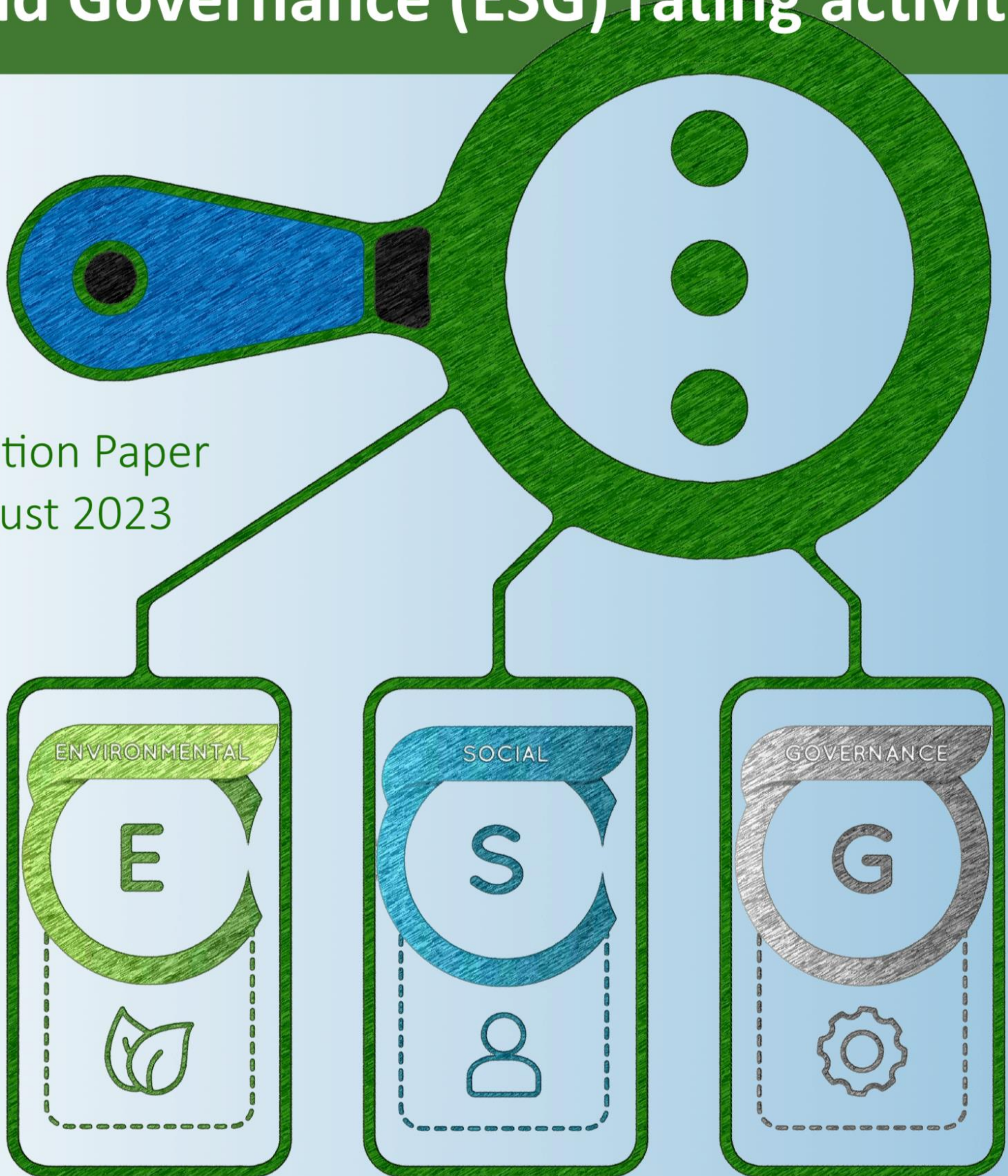
BETTER FINANCE position on the transparency of Environmental, Social and Governance (ESG) rating activities



Position Paper
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BF BETTER FINANCE

The European Federation of Investors and Financial Services Users
Fédération Européenne des Épargnants et Usagers des Services Financiers

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EXECUTIVE SUMMARY

What is an ESG rating?	In simple terms, ESG ratings are **opinions, scores or combination of both**, which **rate a financial instrument/product or a company's ESG profile**. The ESG refers to Environmental, Social and Governance elements whereby investors for example can screen for ESG funds and companies that respectively take into account carbon footprint, employee wellbeing or diversity of the board of directors. There are **various types of ESG rating systems** and **scales** for issuers and funds, which involve **categories** (CCC to AAA, low to high), **scores** (points or percentiles), **combinations** (class 1 to 4 or ESG1 to ESG4) and **many others**. The main challenge with ESG ratings is that **they are not comparable between different platforms** – since some utilise categories while others use scores, where in addition each provider weighs these factors differently.
Who provides ESG ratings and who uses them?	ESG ratings are **usually provided by specialised entities** and are **used by financial institutions, professional investors and small individual investors**. Asset managers, benchmark administrators or other financial institutions can also develop ESG ratings, but for their own purposes. In the case of asset managers, in-house ESG ratings of own investment funds are used mainly for their investment decisions. Companies may use ESG ratings to seek investment opportunities and to consider risks as well as verify their performance against ESG factors within their respective peer group. Even though ESG ratings are typically sold to professional investors (asset managers), **retail investors - typically not purchasing ESG ratings – use the ratings to base their investment decisions**. However, both sides (asset managers and individual investors) face **increasing difficulties regarding the reliability of ESG ratings**.
European Commission draft Regulation on ESG ratings	The draft Regulation proposed by the European Commission in June 2023, **aims to establish a framework and tackle structural issues by combating possible conflicts of interests, imposing better transparency in the rating processes, and introducing an authorisation and supervision system for ESG rating providers** (for both EU and non-EU entities). Although commendable, the proposal **cannot fully fulfil its objective for reliable and comparable information**, since transparency requirements are not coupled with standardised or harmonised set of minimum metrics that would ensure each ESG rating provider takes into account within its ratings. BETTER FINANCE **urges the European Parliament and Council of the EU to amend the proposal** during the EU legislative process and **ensure its timely adoption**.
Transparency vs harmonisation	Transparency of methodology is key for an aggregated ESG score, since providers apply different weightings to the individual dimension score (E, S, or G) based on the specific sector, thus artificially inflating the overall ESG score. Having **the methodology publicly available is of utmost importance for non-professional investors** in order to make informed investment decisions and trust that their investment objectives are met (e.g. to deliver a positive impact, or specifically support green transition, etc). However, this is only one side of the coin. Harmonizing ESG reporting would hold firms accountable to their commitments. While it comes naturally that differences between platforms will exist – either due to proprietary characteristics or due to "unique selling points" – it is also important to **ensure that ESG ratings are sufficiently homogenous**. This is necessary to empower the "retail" investor and **avoid confusion and mis-selling**. In the **absence of a certain degree of harmonisation**, **reliability cannot be ensured** and, thus, **trust in the financial sector cannot be restored.**

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About BETTER FINANCE
BETTER FINANCE, the European Federation of Investors and Financial Services Users, is the public interest non-governmental organisation advocating and defending the interests of European citizens as financial services users at the European level to lawmakers and the public in order to promote research, information and training on investments, savings and personal finances. It is the one and only European-level organisation solely dedicated to the representation of individual investors, savers and other financial services users.

BETTER FINANCE acts as an independent financial expertise and advocacy centre to the direct benefit of European financial services users. Since the BETTER FINANCE constituency includes individual and small shareholders, fund and retail investors, savers, pension fund participants, life insurance policy holders, borrowers, and other stakeholders who are independent from the financial industry, it has the best interests of all European citizens at heart. As such its activities are supported by the European Union since 2012.

BETTER FINANCE position and recommendations

The draft Regulation urgently needs to:

- **expand protection** provisions for retail investors **against greenwashing;**
- **establish** a minimum sustainability requirement for ESG ratings to ensure **certain degree of harmonisation** between providers going beyond transparency **of methodology;**
- **include** a requirement which can address conflicts of interest by integrating **clearly labelled ratings' origin** and who it is paid by (i.e fund rating: warning, rating paid by the fund manager etc.).

ESG ratings and what this means for investors

ESG ratings providers should already communicate better to explain whether they rely more on ESG disclosure scores based on company-reported ESG data, on third-party partner data, or on their own research. Particularly in financial markets, given that ESG and sustainability integration has become common to most financial instruments and products, due diligence of rating providers is becoming a duty of public interest towards the frictionless functioning of the market. Therefore, readability, comparability and transparency of ESG ratings remains extremely important.

In order to ensure protection of retail investors against greenwashing with ESG ratings, they should not be expected to research and acquire specialised insight into the complex market of ESG ratings. Any shift of responsibility onto users in general and to investors, especially regarding aspects of due diligence in the complex and non-transparent methodologies as applied by ESG rating agencies, must be avoided. Instead, the information made available by providers should be of high quality in order to ensure that the investment decision making process of "retail" investors is not corrupted. So far, companies from highly polluting industries could get high environmental scores from some ESG rating providers, which results in investor confusion and further undermining of the trust in sustainable finance products as well as expansion of greenwashing practices.

One of the ways the proposed Regulation can address these concerns is indeed by fulfilling the objectives of the legislation – provide reliable and comparable information – by granting some control to ESG rating providers in regard to their methodologies in use, but requiring a minimum set of metrics that each provider must utilise in order to ensure real comparability of ratings and scores. The diversity of ESG ratings (scales, scores, rankings, etc.) and their methodologies make most of these financial market data products incomparable with one

another, thus creating smaller markets for ESG ratings where, usually, there is an oligopoly or monopoly.

ESG ratings provider	Rating scale
Provider A	**AAA** (highest) to **CCC** (lowest)
Provider B	**10** (highest) to **0** (lowest) for overall Environmental, Social and sub-issues
Provider C	**AAA** (highest) to **D** (lowest)
Provider D	**100** (highest) to **0** (lowest) using sector comparison

BETTER FINANCE supports standardisation and harmonisation of ESG ratings in the interest of simplicity, fairness, and transparency, and is not opposed to competitive solutions and a sufficiently wide variety of solutions proposed to the market, as long as a certain level of comparability can be maintained regardless of the "unique selling points" of ESG rating providers.

ESG rating methodologies appear biased towards awarding most companies high rankings (or otherwise scores, ratings, points, depending on the methodology). For example, an ESG rating provider can analyse and qualify the ESG rating of companies in comparison with their peer group, divided by specific sectors of activity. This leads to situations which natural resources extracting companies or tobacco manufacturers can receive the same ESG rating as a renewable energy company (in its respective peer group). Therefore, certain data providers do not break down all parameters, while others may only display them aggregated – with a risk of favouring some (sub-)factors over others.

Importantly, having each dimension of ESG visible as a score and by using a common set of metrics for each of environmental, social and governance factors, will provide a better picture to investors and ultimately help users of the ratings better understand companies' and funds' performances for example and inform their investment decisions.

Conflicts of interest

The proposal on ESG ratings aims to prevent conflicts of interest which may arise when an ESG rating provider also offers other ESG related services to companies without any clear separation and independence of business interests. Establishment of an independent oversight function as well as separation of such business activities is welcome and important step in ensuring integrity of ESG ratings as well as confidence in investors having access to unbiased information.

Categories of ESG rating providers (non-exhaustive list)	
Benchmark administrators	Some index providers such as MSCI and FTSE Russell produce ESG ratings and use them to create ESG indices
Data vendors	Data platforms (e.g. Bloomberg and Refinitiv) make ESG ratings available to clients subscribing to their services, while fund data providers such as Morningstar or Refinitiv Lipper use ESG ratings to rank funds based on their portfolios
Consultancies	Some consultancy firms produce ESG ratings on specific aspects or segments of the market (unlisted companies and fund investment strategies respectively) to inform their investors

There is some overlap between these categories, where for example ratings offered by some can serve as input to both benchmark indices and fund ESG ratings. This raises concerns about the payment model used and how much this influences the ESG rating as a consequence. ESG rating providers operate on an "investor pays" business model. However, a number of ESG rating providers both sell ESG ratings and / or scores to investors and ESG analysis or consulting services to issuers. This creates a conflict of interests when the companies buying the consulting services are rated by the rating provider. Institutions selling ESG ratings to investors should therefore be prohibited from selling any form of ESG related services to the issuers on which they provide ESG ratings or scores.

To mitigate such conflicts the draft Regulation should require clear labelling of ESG ratings paid for by issuers or fund managers for example. Additionally, under the 'investor pay' model (professional investors such as asset/fund managers) non-professional investors are de facto excluded. While the draft Regulation stipulates some measures for fair, reasonable, transparent and non-discriminatory treatment of users of ESG ratings, it lacks details on concrete meaning for end users, i.e retail investors, consumers and others alike.

Way forward: improving ESG investing approaches

Aside from strengthening the protection provisions for retail investors against greenwashing, requiring a certain level of homogeneity with ESG rating methodologies, labelling ESG ratings and clearly informing end-users of the consequences in relation to the fees based model of the proposed Regulation, the EU should also consider how to address the current investment strategies in use.

There are various investment strategies used by asset managers, most commonly involving screening – both positive and negative (exclusion) – and less widely used approach of engagement. Engagement, otherwise knows and referred to as 'stewardship' is a form of active share ownership aiming in particular at increasing the focus of the corporate investment plans and business model of companies towards a low carbon pathway for example.

What are the main ESG investing approaches used by asset managers?	
Exclusion-based	Also known as *negative screening*, it means that companies are excluded from the portfolio of investment funds based on some specific criteria established by the asset manager.
Integration-based	The asset manager selects certain companies based on some specific environmental, social and governance characteristics. This technique is also called *positive screening*.
Engagement	This approach intends to provide added value by establishing regular dialogue with the investee companies in the portfolio holdings in order to help them (or push them) to improve their environmental, social and governance performance.

Impact	This investing technique intends to maximise the environmental, social and governance performance of the fund by providing concrete and measurable impacts of the investments on the real economy.

However, most are focused on the so called 'best in class' investment strategy i.e comparing relative ESG performance of a company against others, instead of absolute performance. While it is important for investors and users of ESG ratings to see how a company is performing in its respective peer group, this practice means that high risk companies are still able to appear within ESG portfolios, which is very confusing for investors and potentially detrimental to the pathway of sustainability. The current role of ESG ratings could be improved to stimulate engagement strategies more frequently as opposed to 'best in class' screening which could be misleading, by requiring ESG rating providers to assess companies with a minimum set of standardised criteria in relation to their engagement practices for each of the ESG branches.

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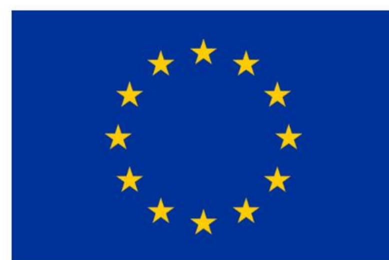

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