Call for an ambitious EU ESG ratings Regulation

15 November 2023

Dear Members of the Economic and Monetary Affairs Committee,

We are writing to you in the context of the crucial ESG ratings Regulation that is currently being discussed in your Committee.

We, the undersigned organisations representing civil society and retail investors, believe that this Regulation represents a unique opportunity to fix the well-recognised ESG ratings' market dysfunctionalities and holds the potential to finally make ESG ratings true sustainability ratings.

Regulating ESG rating agencies is a central piece of the EU sustainable finance agenda, as ESG ratings are currently far from portraying a valid picture of a company's sustainability credentials. Instead of ensuring that the best-performing companies get the recognition and financing they need, unregulated ESG ratings are already misleading asset managers, investors and policymakers. Ultimately, the continuation of their flaws risks exacerbating greenwashing on financial markets.

We believe that the text proposed by the European Commission provides a good basis to the regulation of the ESG ratings market in Europe, mostly in terms of transparency. We also welcome the Rapporteur's proposed improvements to the Commission's proposal with regard to transparency, conflicts of interest and a separation between E, S and G ratings. However, we regret that a central dimension remains absent from this proposal: **mandatory double materiality and other minimum quality requirements for ratings.**

ESG ratings are meant to provide an assessment of undertakings' sustainability performance in environmental, social and governance matters. Yet, it has been widely demonstrated[1], including in the Commission's own impact assessment[2] and reference studies[3], that **they currently mainly address the financial risks and opportunities** for rated undertakings related to ESG conditions (financial materiality), rather than the impact of said undertakings on the environment and society (impact materiality). We strongly believe that integrating the latter is crucial to ensure that ESG ratings become true sustainability ratings. The absence of a correlation between ESG ratings and impact materiality leads to inaccurate evaluations of companies' sustainability performance and the risk of greenwashing.

In addition, to reinforce the comparability and quality of the ratings, we believe that the metrics assessing material ESG dimensions should at the very minimum be linked with relevant international frameworks, namely, the Paris Agreement and the latest IPCC recommendations, core International Labour Organisation standards, the UN Guiding Principles on Business and Human Rights, as well as the OECD Principles of Corporate Governance.

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[1] ESG Ratings: whose interests do they serve?, Financial Times, October 3, 2023 (Link)
[2] EU Commission impact assessment report (Link)
[3] ERM (November 2020), Study on Sustainability-Related Ratings, Data and Research, (Link); Blackrock (August 2021), Final Study on Development of Tools and Mechanisms for the Integration of ESG Factors into the EU Banking Prudential Framework and into Banks' Business Strategies and Investment Policies (Link); J. Fichtner, R. Jaspert, J. Petry (2023) Mind the ESG capital allocation gap: The role of index providers, standard-setting, and "green" indices for the creation of sustainability impact (link) .

Furthermore, extensive empirical research[4] has highlighted that the combination of ESG ratings with other activities such as credit ratings, consulting, investing and auditing by the same group can seriously undermine the authenticity of ESG ratings. We therefore call the co-legislators to separate activities at the group level. We simultaneously support all proposals by the Rapporteur and other MEPs to strengthen the provisions against conflicts of interest and their enforcement.

Finally, we believe that the use of data published under the Sustainable Finance Disclosure Regulation, the Corporate Sustainability Reporting Directive, the EU Taxonomy Regulation and potentially the upcoming Corporate Sustainability Due Diligence Directive in ESG ratings should be made mandatory. This would ensure better coherence and harmonisation across EU legislation.

This is a unique opportunity to create an overarching piece of legislation that can connect the dots between existing legislation, bring more clarity to the sustainable finance agenda, and accelerate the allocation of investments towards companies making meaningful transition efforts to contribute to the Green Deal and the EU environmental targets. In addition, providing maximum transparency in the ESG ratings agencies' websites will substantially increase the reliability of ratings and public and investors' trust in them.

We therefore urge you to preserve the initial purpose of this Regulation to improve the reliability, comparability and transparency of ESG ratings in the EU and in particular to:

1. **mandate ESG ratings to follow a double materiality approach, therefore taking into consideration companies' exposure to ESG risks, but also and most importantly their ESG impacts on the outside world being a significant part - at least 50% - of the metrics.**

2. **ensure balanced use of differentiated "E", "S", and "G" ratings, linking "E" to the degree of alignment with a 1.5°C pathway (GHG emissions reduction) and the phase-out of fossil fuels and S to international core labour and human rights standards.**

3. **reinforce the coherence of this Regulation with existing EU legislation (Corporate Sustainability Reporting Directive, Sustainable Finance Disclosure Regulation and the EU Taxonomy) so that data disclosed by companies is computed in meaningful ratings that can be used by investors and asset managers to channel their funds to the most sustainable companies.**

4. **enhance the Commission's ambition to improve public transparency of methodologies, for instance, on assessment of ESG impact, and prevent conflicts of interests.**

5. **exclude from the scope of the regulation non-profit civil society organisations that put together scoreboards or rankings for non-commercial purposes and that make these freely accessible.**

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[4] ESG Ratings: whose interests do they serve?, Financial Times, October 3, 2023 (Link); X. Li, Y. Lou, L. Zhang (2023), Do Commercial Ties Influence ESG Ratings? Evidence from Moody's and S&P, (link; D. Yongjun Tang, J. Yan, C. Yaqiong Yao (2022), The determinants of ESG ratings: Rater ownership matters (link).

We remain at your disposal for any further questions.

Sincerely,

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

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