CALL FOR EVIDENCE
FOR AN IMPACT ASSESSMENT

This document aims to inform the public and stakeholders about the Commission's work so they can provide feedback on the intended initiative and participate effectively in consultation activities.

We ask these groups to provide views on the Commission's understanding of the problem and possible solutions, and to give us any relevant information they may have, including on the possible impacts of the different options.

Title of the initiative	*ESG ratings and sustainability risks in credit ratings*
Lead DG – responsible unit	DG FISMA – Unit Corporate Reporting, audit and credit rating agencies - Unit C1
Likely Type of initiative	Legislative or non-legislative action based on the outcome of an impact assessment focused on strengthening the reliability and comparability of ESG ratings Possible targeted revision of the legal framework related to CRAs or non-legislative measures to strengthen the transparency about ESG factors in credit ratings.
Indicative Planning	Impact Assessment 2022, possible legislative or non-legislative initiative by Q1 2023
Additional Information	

This document is for information purposes only. It does not prejudge the final decision of the Commission on whether this initiative will be pursued or on its final content. All elements of the initiative described by this document, including its timing, are subject to change.

A. Political context, evaluation, problem definition & subsidiarity check

Political context

The Strategy for financing the transition to a sustainable economy, published in July 2021, has announced a need to assess the scope for further policy initiatives on sustainability ratings and credit ratings. This initiative is composed of 2 separate parts focusing on: 1) the operations of Environmental, Social and Governance (ESG) ratings providers; 2) how credit rating agencies (CRAs) incorporate ESG risks in their creditworthiness assessment. These actions are expected to contribute to the achievement of the European Green Deal objectives by improving the quality of information on which basis investors, businesses and other stakeholders take decisions impacting the transition to a sustainable economy.

It is important to distinguish ESG ratings from credit ratings. Both credit ratings and ESG ratings are opinions provided by specialised entities and used by financial institutions and professional investors. The term ESG ratings refers to a wide and heterogeneous group. There is no single definition of ESG ratings although it can be said that ESG ratings generally assess the impact of E, S and G factors on a company and/or a company's impact on the outside world. Credit ratings to the contrary are precisely defined and they assess the creditworthiness of companies or financial instruments by providing an opinion on one type of financial risk, namely the risk of default of a company.

1- ESG Ratings

Investors increasingly use ESG ratings as part of their sustainable investment strategy to take into account risks and opportunities linked to ESG issues. Consequently, these ratings have an increasing impact on the operation of capital markets and on the confidence of investors in financial products. ESG rating providers are however not subject to authorisation or supervision at EU or national level at present. Due to the importance and growth of this market, the Commission undertook a study ('the Study') to analyse potential issues with its functioning. The Study on Sustainability-related ratings, data and research[1] was published in January 2021 and identified a number of concerns. This initiative also has an important global dimension, with large ESG rating providers located outside

[1] https://op.europa.eu/en/publication-detail/-/publication/d7d85036-509c-11eb-b59f-01aa75ed71a1

the EU currently providing services to investors located in the EU. The role and functioning of ESG rating providers is also an issue of global concern and the International Organization of Securities Commissions (IOSCO) published in November 2021 a set of recommendations calling for oversight of ESG rating providers[2]. Market participants have indicated that a better understanding of what ESG ratings assess and increased reliability of ESG ratings would enhance the trust in and credibility of this fast-growing market, thereby facilitating progress towards the objectives of the Green Deal.

2- Credit Ratings

Credit ratings are opinions about factors that may affect creditworthiness, including sustainability factors, where relevant. Changes in credit ratings or rating outlooks may have important impacts on financial markets, financial stability and the broader economy. Credit ratings are important for the calculation of prudential requirements under the EU's Capital Requirements Regulation (CRR) and Solvency II and are used by the European Central Bank for its open market operations. The EU legal framework regulates the credit rating agencies (CRAs) with a view to protecting investors and financial markets by requiring the transparency, independence and integrity of the credit rating process. The European Securities and Markets Authority (ESMA) registers and supervises all CRAs operating in the EU.

Problem the initiative aims to tackle

1- ESG Ratings

The Study identified a number of concerns on the functioning of the market for ESG ratings, in particular on the transparency around data sourcing and methodologies, as only a few firms disclose the underlying indicators or their weights in the resulting rating. The Study also highlighted problems in terms of timeliness, accuracy and reliability of ESG ratings. Another issue identified related to biases, and different ratings based on the size and location of companies. Finally, it highlighted potential conflicts of interest, including where providers offer a number of different services, such as assessing companies and at the same time offering paid advisory services or charging companies to see their own reports. Market participants confirmed the existence of the shortcomings identified in the Study.

2- Credit Ratings

The CRA Regulation [3] requires CRAs, in their independent assessment to take into account all factors relevant for the assessment of creditworthiness, including sustainability-related risks. In 2019, ESMA concluded that CRAs are considering E, S or G factors in their credit ratings, but that the extent to which each factor is considered varies between CRAs and by asset class, according to the importance assigned to that factor by each CRA's methodology. ESMA also found that CRAs are not sufficiently transparent as to which changes to credit ratings have been driven by ESG factors. This has led ESMA to adopt guidelines on how CRAs should inform investors of which credit ratings have been influenced by ESG risks and explain which type of risk was material. Recent assessment of the application of the guidelines revealed some improvement, but also that improvements are not uniform across CRAs and the gap between best- and worst-performing CRAs has increased. While some CRAs have announced plans to improve their transparency, it remains likely that this problem would persist. ESMA is currently working on a thematic review, which should provide further information on how CRAs methodologies incorporate ESG factors.

Basis for EU action (legal basis and subsidiarity check)

Legal basis

The Treaty on the Functioning of the European Union (TFEU) confers to the European Union the competence to lay down appropriate provisions that have as their object the establishment and functioning of the internal market

[2] Environmental, Social and Governance (ESG) Ratings and Data Products Providers Final Report, available at: https://www.iosco.org/library/pubdocs/pdf/IOSCOPD690.pdf

[3] Regulation 1060/2009; OJ L 302, 17.11.2009, p. 1–31.

(Article 114 TFEU). Depending on the results of the impact assessment - which will determine the type, exact scope, objectives and content of the initiative - the relevant legal basis could be Article 50(g) on coordinating safeguards required of EU companies by Member States with a view to making such safeguards equivalent throughout the Union, and/or Article 53(1) TFEU on the taking-up and pursuing of activities by self-employed persons.

Practical need for EU action

1- ESG Ratings

The objective of this initiative (i.e. strengthening the reliability and comparability of ESG ratings) cannot be sufficiently achieved by Member States acting independently and action at EU level is necessary for the proper functioning of EU capital markets. Although Member States could individually take action to strengthen the reliability and comparability of ESG ratings, such measures are likely to be significantly different between Member States, which may create diverging levels of transparency, barriers for market participants and challenges for those operating across borders, in addition to limiting comparability between ratings. This would also lead to an uneven protection of investors. With the absence of rules on the operations of ESG rating providers, the situation as it stands today and issues relating to transparency would continue and could even worsen.

2- Credit Ratings

CRAs are regulated and supervised at EU level. Therefore, any changes in the legal framework applicable to CRAs will have to be done there.

For these reasons, this initiative is considered to be in accordance with the principle of subsidiarity as set out in Article 5 of the Treaty on European Union (TEU). In accordance with the principle of proportionality, this initiative will not go beyond what is necessary in order to achieve its objective. In particular, in order to minimise the burden on companies and supervisory authorities, it would build as much as possible on existing practices.

B. Objectives and policy options

The main objectives of this initiative are to **strengthen the reliability, and comparability of ESG ratings** and to **ensure that** relevant **ESG risks are captured in credit ratings**. The specific objectives of the initiative are as follows:

For ESG ratings:

- Define ESG ratings,
- Improve transparency on the operations and methodologies of ESG rating providers,
- Improve the comparability of ESG ratings,
- Avoid potential conflicts of interests of ESG rating providers,
- Limit the risks of greenwashing and social washing,
- Introduce proportionate oversight over the operations of ESG rating providers,

For credit ratings:

- Improve transparency on the impact of ESG risks on individual credit ratings,
- Improve transparency of how CRAs methodologies incorporate sustainability risks,
- Ensure that CRAs methodologies adequately incorporate all relevant sustainability risks.

Depending on the results of the impact assessment, the Commission could consider the following policy options to achieve the above.

Concerning ESG ratings, the Commission will explore the use non-binding guidelines or other soft-law measures as well as the need to propose new legislation on the operations of ESG rating providers. Such legislation could, for instance, set rules regarding i) the authorisation of ESG rating providers, ii) their operations and transparency of their methodologies, iii) rules on conflicts of interests and separation of departments (e.g. ESG rating from other consultancy activities), iv) sanctioning regime and v) a supervisory regime at EU level.

As regards credit ratings, the Commission will_explore the use of further supervisory powers and further use of guidelines, e.g. ESMA could revise its Guidelines applicable to credit ratings to make the disclosure more granular; or to amend the CRA Regulation to clarify the rules on disclosure and requirements regarding the integration of ESG factors in credit ratings.

C. Likely impacts

ESG ratings

This initiative should improve reliability and comparability of ESG ratings and transparency towards their users. It has a strong potential to further improve the protection of investors against potential greenwashing or unreliable ratings, including on social and governance factors. This is expected to lead to better, data-driven decisions that facilitate an orderly transition to a sustainable economy. Where companies themselves use ESG ratings, it could give them more clarity on how they are rated, enable them to better reflect the ratings in their operations and help them compare to their competitors. This could have significant economic impact and improve allocation of capital. More reliable and transparent ESG ratings may lower due diligence costs for those investors who decide to replace a part of their own analysis by using such ratings.

Depending on the option chosen, this initiative may lead to costs and administrative burden for ESG rating providers, as they are currently not subject to any rules or oversight. These costs could possibly be passed onto the users. It might also have some impact on the level of competition in the ESG ratings market, which will be considered in the impact assessment.

Credit ratings:

The systematic capturing of relevant ESG risks in credit ratings and the increased transparency should benefit financial institutions, investors and provide further clarity for rated companies. Investors, and financial institutions will have better understanding of the links between credit risks and sustainability risks.

Most CRAs claim that they already publish how they capture ESG risks. If these claims are verified, further measures considered under this initiative should not lead to significant additional costs.

D. Better Regulation instruments

Impact assessment and evaluation

An impact assessment is being conducted to support the preparation of this initiative and feed into the Commission's decision.

Consultation strategy

In addition to the evidence already collected, notably through the stakeholder consultation in preparation of the renewed sustainable finance strategy and the Study, the Commission is organising a targeted consultation to hear the views of market participants and other stakeholders. This consultation seeks input in relation to (inter alia) the issues with the functioning of the ESG ratings market, their level of transparency and potential solutions to remedy these and the extent to which CRAs integrate ESG risks. The targeted consultation is available here.

The services of the Commission will further organise targeted interviews and meetings with stakeholders and organise dedicated workshops in Q1/2022 with a wide set of stakeholders including ESG rating providers, CRAs, investors, company representatives, other users of public reports and supervisors in order to complement the evidence gathered through the targeted consultation. The services of the Commission will also consult Member States.

The Commission services intend to publish a short factual summary of the responses to the targeted consultation on the consultation page within 8 weeks of the closing of the consultation period and to summarize all relevant consultation activities relevant to this initiative in a synopsis report attached to the impact assessment.

Why we are consulting?

This consultation, together with earlier stakeholder consultation activities and other evidence, will directly feed into

an impact assessment that the Commission will prepare in 2022 with a view to possibly proposing legislative or non-legislative initiatives in Q1 2023. This consultation seeks stakeholder views about the use of ESG ratings by market participants and the dynamics of the market, its functioning and potential issues, but also information on potential costs of an intervention at EU level. It also seeks views on the degree sustainability risks are captured in credit ratings. Finally, the consultation contains specific questions relating to the need and appropriate type of EU intervention.
Target audience
The main stakeholders identified are i) ESG rating providers, ii) CRAs iii) investors, iv) companies, v) public authorities including supervisors and vi) civil society including NGOs, academics. Other interested stakeholders are welcome to contribute.