Sustainability in credit ratings and benchmarks

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EBI European Banking Institute

Agenda

- Some basics
- Market considerations
  - ESG Ratings
  - ESG benchmarks
- Regulatory considerations: an analytical model
  - Exit
  - Voice
  - Penalty/Coercion
- Conclusions

Some basics

- Globally: 'largely unregulated' activities (IOSCO. (ESG) Ratings and Data Products Providers. 2021)
- Ratings
  - ESG ratings are **not 'regulated ratings'** under CRAR → they do not measure probability of default
  - Differences: '**risk ratings**'. Most common, measure entities' exposure to ESG risks and their management ('**outside in**')
  - '**Impact ratings**'. Measure impact of entities on ESG factors ('**inside out**')
- Benchmarks
  - ESG benchmarks **are 'regulated' benchmarks** (Reg. 2016/1011). Art. 3 (1) (3) Broad definition: 'any index by reference to which the amount payable under a financial instrument or a financial contract, or the value of a financial instrument, is determined, or an index that is used to measure the performance of an investment fund with the purpose of tracking the return of such index or of defining the asset allocation of a portfolio or of computing the performance fees;'
  - +
  - **Sequenced model**:
    - **'Critical'** (Art. 20): external auditing, mandatory administration, mandatory contribution
    - **'Significant'**: authorisation/registration; comply-or-explain (strict)
    - **'Non-significant'**: registration; comply-or-explain (lenient)
  - **Easier to** bring into the regulatory perimeter & **calibrate**

Gargantini; Siri 'Information Intermediaries and Sustainability: ESG ratings and benchmarks in the EU' ***ECMI*** **WP 2022**

Market considerations: ESG Ratings

- ESG rating providers.
  - **Credit Rating Agencies** – CRAs (S&P, Moody’s, Fitch Ratings)
  - **Benchmark administrators**: MSCI, FTSE Russell
  - **Data vendors**: fund data providers (e.g., Morningstar, Refinitiv Lipper) or data platforms (e.g., Bloomberg)
  - **Specialised firms**: e.g., Sensefolio, Ecovadis

Source: ESMA. ESG ratings: Status and key issues ahead, 2021

Market considerations: ESG Ratings

- ESG rating providers. ESMA Call for Evidence
  - Largely located in **3 Member States** (Germany – 12; Italy - 8, France - 7) with Spain 4th (4); majority of independent legal entities; non-listed (84%)
  - <u>1/3</u> subject to regulatory <u>authorisation</u> (other services); <u>2/3 not</u>
  - Majority (73%) offered <u>other ESG data products</u>; 1/3 "for-profit large providers".
  - **<u>Average</u> revenue**: EUR 22,7 million; **<u>median revenue</u>**: EUR 5,5 million
  - How to make sense of this?

Source: ESMA. Outcome of Call for Evidence ESG ratings & data providers. 2022

Market considerations: ESG Ratings

- Providers (consolidation)

Recent acquisitions

Year	**Target**	**Acquirer**
2016	Trucost (UK)	S&P Global (US)
2017	Sustainalytics (Netherlands) – acquisition of a 40% stake	Morningstar (US)
	South Pole (Switzerland) (Investment Climate Data Division)	ISS (US)
2018	Solaron (India)	Sustainalytics (Netherlands)
	Oekom (Germany)	ISS (US) (acquired in 2020 by Deutsche Börse Group)
2019	Vigeo-Eiris (France)	Moody's Corp (US)
	Beyond Ratings (France)	London Stock Exchange (UK)
	Four Twenty Seven (US)	Moody's Corp (US)
	GES International (Sweden)	Sustainalytics (Netherlands)
	Carbon Delta (Switzerland)	MSCI (US)
	SynTao Green Finance (China)- minority stake	Moody's Corp (US)
	Ethical Corp (US)	Thomson Reuters (US)
	Robecosam AG-ESG ratings Business (Switzerland)	S&P Global (US)
2020	Sustainalytics (Netherlands) – 100% stake	Morningstar (US)
	Ecovadis (France) - Non-controlling interest	CVC Growth Partners (US)
	TrueValueLab (US)	Factset (US)

Source: IOSCO. (ESG) Ratings and Data Products Providers. Table 1

Market considerations: ESG Ratings

- **Users. Commission Targeted Consultation use of ESG ratings 2022**
  - Majority of respondents use ESG ratings, and **77% 'very much'**
  - Large majority (81%) use <u>**combination**</u> of overall ESG ratings. Majority (61%) buy ESG ratings <u>**as part of a package**</u>, with other ESG data/services (screening, controversy alerts, benchmarks, regulatory compliance checks, fund ratings)
  - Almost ALL respondents expect the ESG ratings market to grow. Majority expect to increase <u>their usage</u> of ESG ratings, often to a large degree
  - Large majority (81%) use ESG ratings <u>mostly or exclusively</u> from <u>large market players</u>. Majority (60%): market conditions difficult for smaller market players to be competitive.

- **Users. ESMA. Outcome of Call for Evidence (CfE) ESG Ratings & Data Providers. 2022**
  - Users (respondents to CfE): largely <u>**regulated institutions**</u>, AIFMD-UCITS, in Germany, Italy, France. High standard deviation in assets under management (large/small asset managers)
  - Most used providers: <u>**MSCI, Morningstar/Sustainalytics, ISS, S&P**</u> (both mentions & investment value)
  - Most (77%) use <u>**more than one provider**</u> to improve coverage & due to divergences; most commonly sought attribute (70%) <u>**depth and breadth**</u> of coverage: variety of companies, KPIs; second most-sought (34%) data quality & transparency of methodology & data. **IOSCO confirms this.**
  - Majority: <u>**investor-pays**</u> (issuer-pays more pervasive than anticipated). **IOSCO** (85%-100% issuer-pay; but ALL issuer-pay ratings-based)

- **Users. IOSCO. ESG Ratings and Data Providers. Nov. 2021**
  - Ratings used in investment decisions, but unclear how (<u>**not systematically**</u>)
  - <u>**No formal verification**</u> (processes) of ESG ratings (*ad hoc* verification): lack of transparency, but also resource intensiveness
  - Complaint: <u>**lack of standardisation**</u> of corporate-level ESG disclosure
  - Development of <u>**internal ratings/capacities**</u> by some users (no comparison external/internal ratings). Resource-intensive for others.

Market considerations: ESG Ratings

- Performance and consistency
  - Industry research: positive **correlation** ESG **scores-performance**; academic research, negative correlation (Boffo, R., and R. Patalano (2020), "ESG Investing: Practices, Progress and Challenges", no evidence ESG-oriented portfolio indices systematically outperform non-ESG índices.
  - **Divergence** between ratings (Berg, F., Koelbel, J. F. and Rigobon, R. (2019),Aggregate confusion: The divergence in ESG ratings, MIT Sloan Research Paper), due to lack of common definition of E – S – G componens (Billio, M., Hristova, I., Latino, C. and Pelizzon, L. (2020), Inside the ESG ratings: (Dis)agreement and performance
  - **CO_2 emissions**
    - **Higher ESG rated companies**, on average, **pollute more** in terms of gross output of carbon dioxide
    - One of 3 providers showed positive correlation between E pillar score and CO2 Emissions
    - Two providers out of three attribute companies with higher Waste Produced higher E pillar scores.
    - Two providers show decreasing energy use for higher E scores, but higher Water Withdrawal for all providers.
  - Users consider that **market is not functioning well** (84%); is **not transparent** (83%); biased (91%); prone to **conflicts of interest** (80%) (Commission Consultation, 2022); ESMA CfE confirms this

Market considerations: ESG Ratings

- Companies being assessed
  - ESMA:
    - Respondents: mostly Germany, France, Italy; large number of banks
    - MSCI (41), Moody's (33), ISS (31), Morningstar/Sustainalytics (24), CDP 22), S&P (20)
    - Complaints about **lack of opportunity to correct errors** (especially unsolicited ratings)
    - Report & feedback slow & cumbersome process + lack of objective reasons for ratings
  - IOSCO:
    - Data collection: **time consuming** for companies; timeliness of questionnaires
    - Data assessment: **lack of engagement & transparency of process**; changes methodology
    - Pre-publication: lack of opportunity to review prior to publication (subscriber-pay)
  - OECD:
    - ESG ratings **bias** against SMEs for some providers

Market considerations: ESG Benchmarks

- ESG benchmarks set to **grow** (annual 35%; Anne-Laure Foubert, 2020-03-09, ESG Data Market; cited by IOSCO Report)
- ESG benchmarks heavily **dependent on ratings** (IOSCO). Some benchmark administrators are also ESG ratings providers (e.g., MSCI, STOXX, Thomson Reuters)
- Benchmarks are **key to investors** (to measure against performance for active managers, to check portfolio composition for passive managers)
- Concentration: **industry increasingly concentrated** (IOSCO). Specifically: "The market for ESG benchmarks is highly concentrated: in December 2020, 17 out of the largest 20 ESG ETFs tracked ESG índices from the same index provider, according to data from ETFGI, with combined assets of EUR 57 bn. With global ESG ETF assets tripling to EUR 121 bn in 2020 and more than half of new European ETFs integrating sustainable criterio into their investment process, the magnitude of these issues seems likely to further increase" ESMA 'ESG ratings: Status and key issues ahead' 2021

Market considerations: ESG Benchmarks

- Performance
  - (Boffo, R., and R. Patalano (2020), "ESG Investing: Practices, Progress and Challenges", OECD) (MSCI, STOXX, Thomson Reuters)
    - Some high-ESG indices and portfolios outperform the market; BUT same is true for low-ESG portfolios. Little differentiation in fund performance with higher-scoring and lower-scoring ESG
    - ESG indexes involve **concentration risk**, BUT may result in **lower future drawdown risk**, if industries/companies excluded will see a future decline. Evidence suggests some lower drawdown risk.
    - **Market capitalisation** has a **strong, positive correlation with ESG scores** for different providers, except for one.
  - Boffo, R., C. Marshall and R. Patalano (2020), "ESG Investing: Environmental Pillar Scoring and Reporting" (OECD) (MSCI, S&P, STOXX)
    - **Exclusionary screening**: indices remove companies, without tilting or integrating ESG scores in different ways.
    - Result? **weight of some industries (Energy) increases** (S&P500 ESG and STOXX600 ESG). By removing companies in some industries, increases the weight of les affected industries → suggests exclusions due to unacceptably low standards in governance/social standards. Portfolio rebalancing shifts investments toward above-average polluters.

Market considerations: summary

- Market considerations: summary
  - Market **grows**… and will grow more
  - Market **IS already concentrated**
    - Economies of **scope** (multi-product offerings); network effects?
    - Players: **large conglomerates** (CRAs, Benchmark administrators, Data vendors) who offer ESG ratings as part of ‘service packages’
  - …This happened independently of regulation
  - Ratings:
    - Issuer-pays: puts pressure on **quantity (coverage) over quality**
    - **Opacity**; conceptual & methodological divergences
    - Users complaints of opacity (fair) & lack of correlation (fair?). They do not systematically check for accuracy
    - Companies complain of **lack of interaction** (good or bad?)
  - Benchmarks
    - ESG indices **do not systematically overperform**
    - **Mixing E – S – G** + Exclusionary methods leads to **odd results** (greater presence of oil majors).

Regulatory considerations

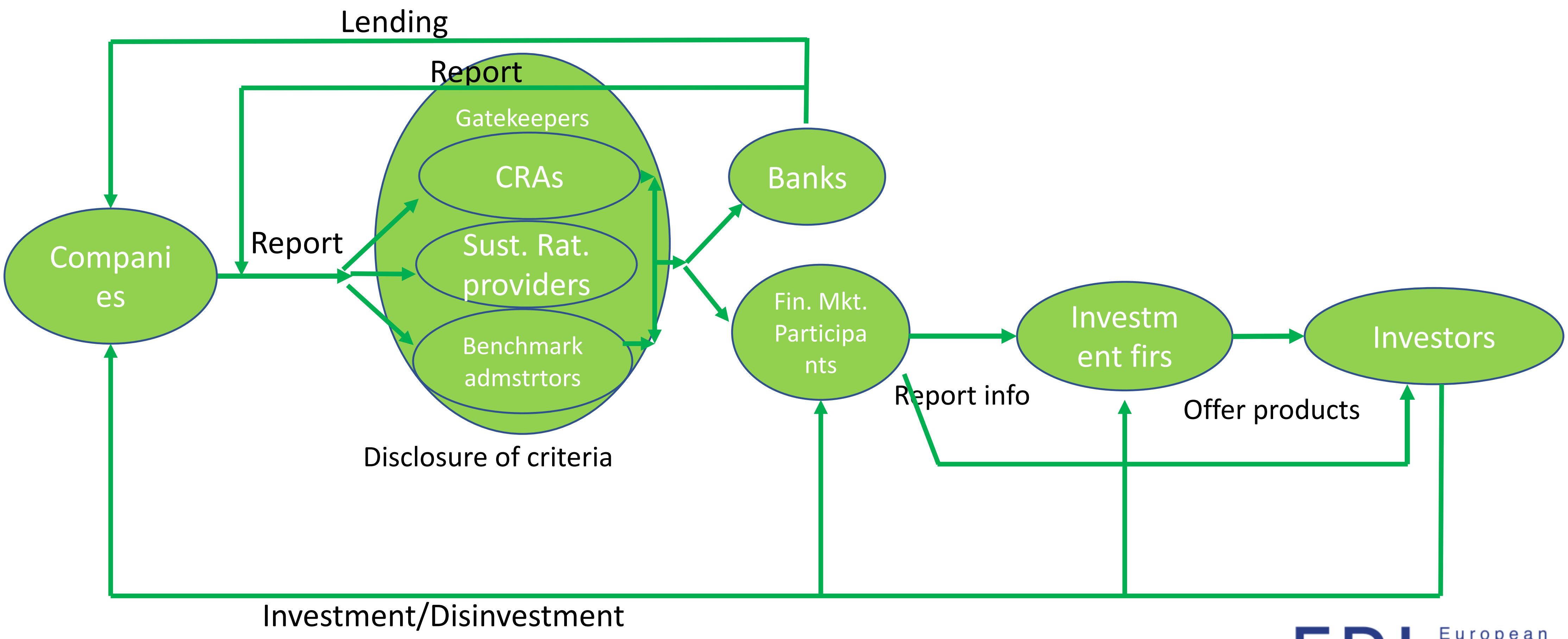
- Some guiding ideas:
  - 1. The approach towards ratings and benchmarks must be consistent with the approach to other market actors (consistency)
  - 2. What are the goals to achieve? (ends)
  - 3. What 'levers' will be used to achieve such goals? (means/dynamics)

Analytical model. Exit, Voice, Penalty/Coercion

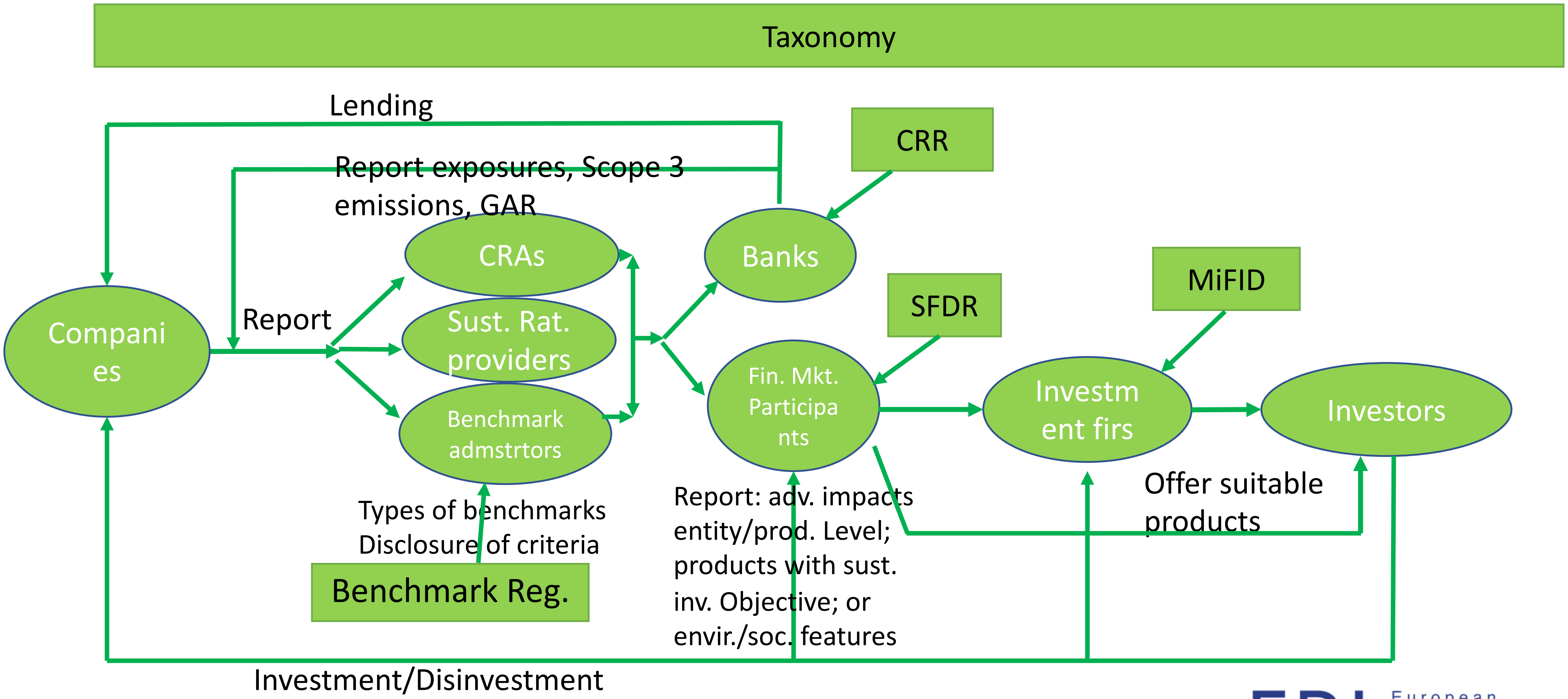
	Rationale	Enabling tools	Type of rules
EXIT	Economic: competition, "voting with your feet"	Transparency, disclosure, clarity of information, etc.	Capital markets disclosure rules
VOICE (*lato sensu*)	PoliSci: an attempt to correct an objectionable state of affairs; engaging & changing the conversation.	Gatekeepers; financial intermediaries' duties of suitability, engagement & avoiding conflicts of interest; sust. relevance at board level	Capital markets, corporate law & any rules that foster 'engagement'
PENALTY/ COERCION	Legal: sanctioning reprehensible behaviour	Liability for (i) contributing to climate change or harming other SDG; (ii) misrepresenting facts or risks; (iii) breaching fiduciary duties.	Civil liability, enforcement provisions of securities and corporate law.

Ramos Muñoz; Cerrato; Lamandini The EU's "Green" Finance. Can "Exit", "Voice" And "Coercion" Be Enlisted To Aid Sustainability Goals? EBI Working Paper Series no. 1/2020.

Exit-based strategy



Exit-based strategy

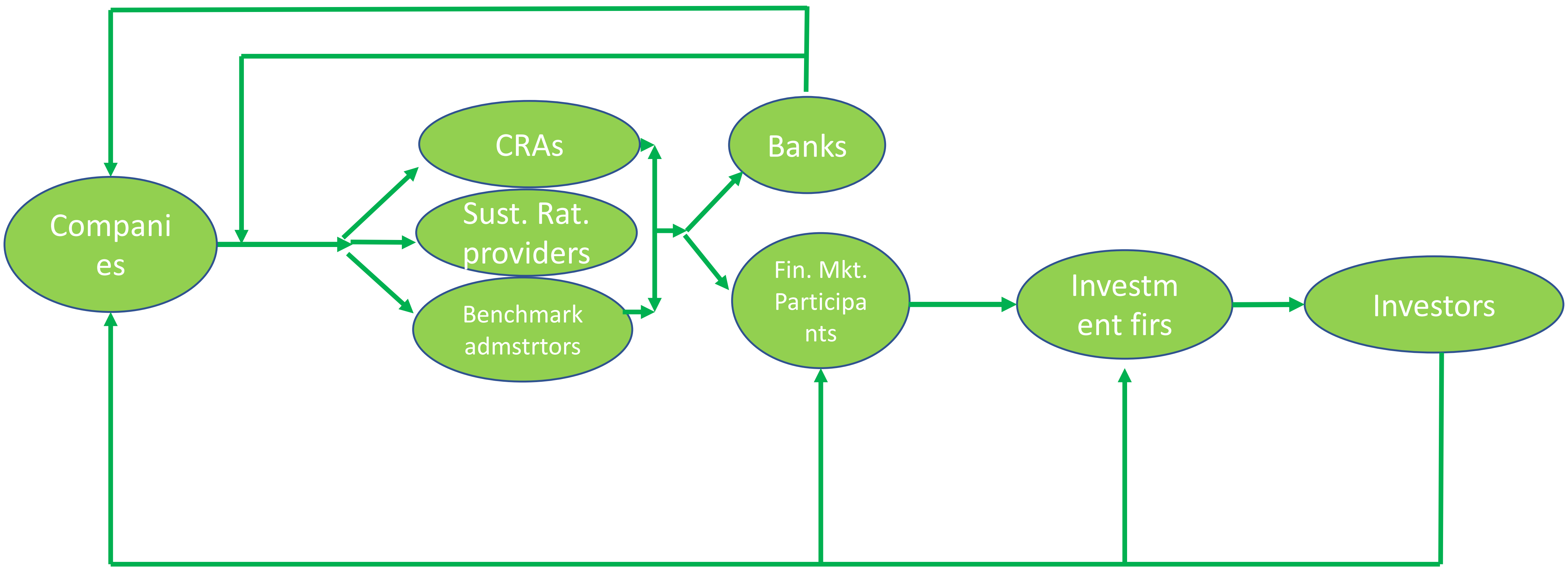


Exit-based strategy

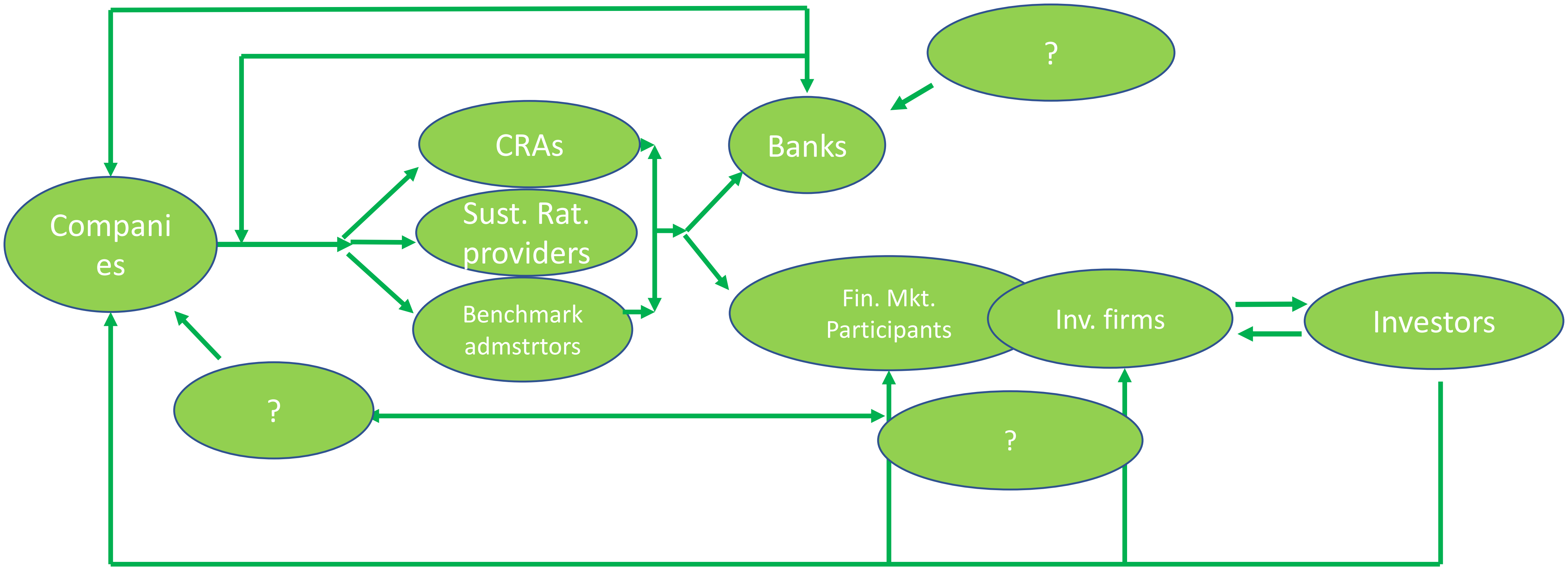
- Investor-led perspective (Gargantini; Siri, 2022)
    - **Diversity of investors** (risk-based/impact-based; static/dynamic)
    - Sustainability Rating Agencies (SRAs) **cannot be CRAs: assessment is different** (E + S + G)
    - Cannot dictate process (discretion). Proposal: **treatment as investment advisors** ('light touch', adaptive, iterative)
    - Market considerations: **avoid overreliance** ('regulatory license')
    - **Reluctance** towards **integrating ESG factors** by 'mainstream' **CRAs** in credit assessments (e.g., ESMA).
- Transition-led perspective:
    - Transition is the goal; supply can create demand (Carney, 2015)
    - **Mixing E – S – G is not a good idea → climate change** as 'core' concern → prioritised & operationalised across the investment chain (already visible in Taxonomy, banks' Pillar 3 disclosures, or Benchmarks)
    - More **intrusive** approach justified for certain **'products'**
        - Climate Transition Benchmarks & Paris-aligned Benchmarks)
        - 'Ratings' should be specifically regulated
    - Market considerations: 'overreliance' depends on **capacity building** among **intermediaries**; **concentration is a fact**
    - Banks need info. on probability of default → **ESG ratings cannot be decoupled from 'regular' ratings**

- Exit-based strategies are going to be insufficient: we talk about market failure

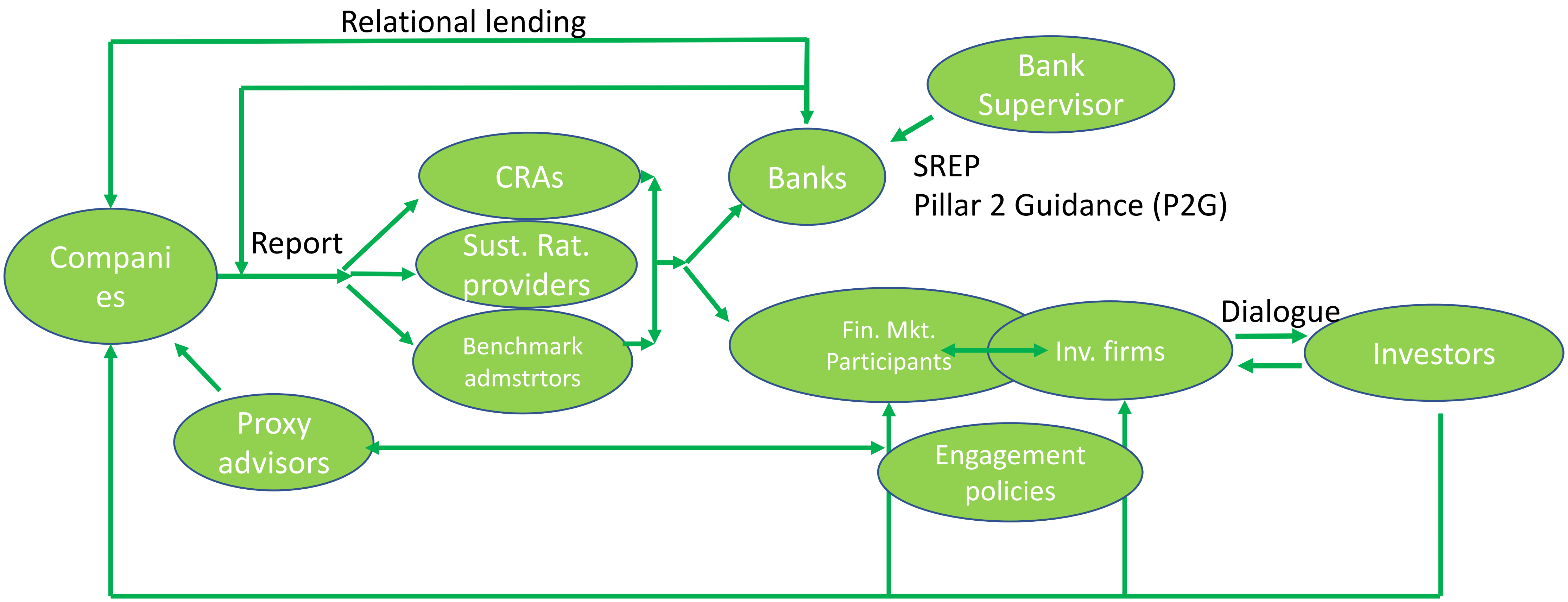
From Exit to Voice



From Exit to Voice



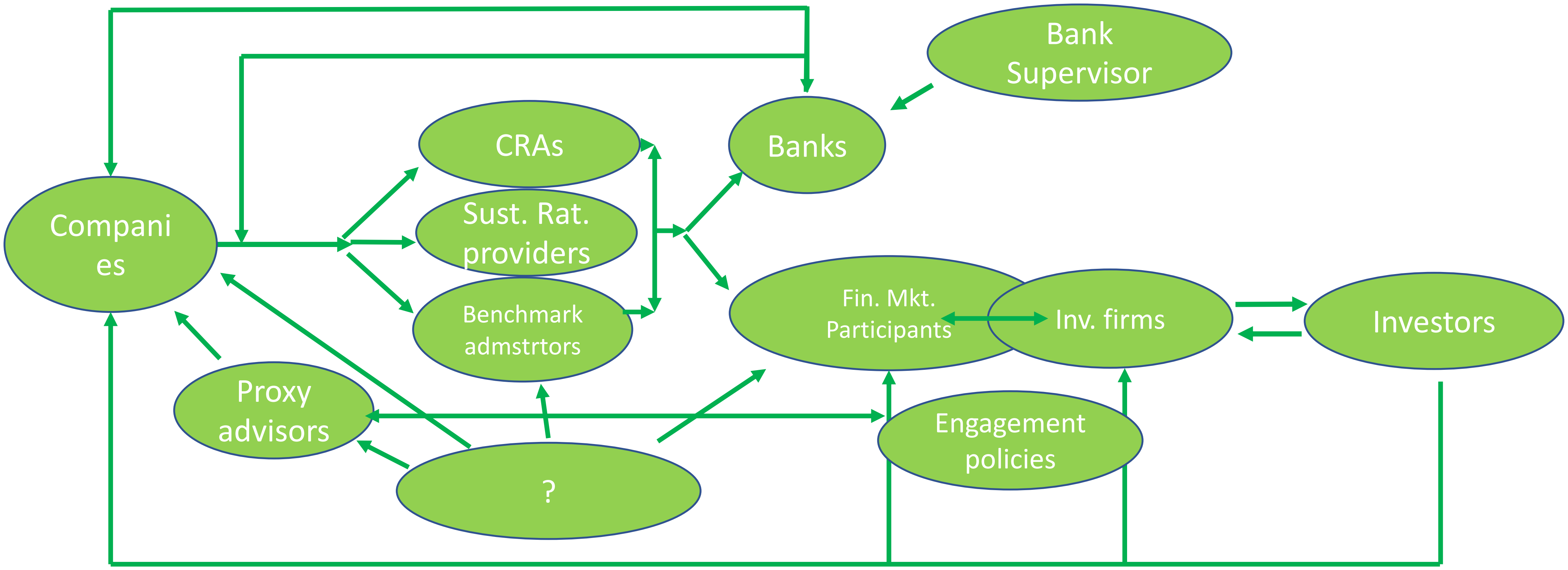
From Exit to Voice



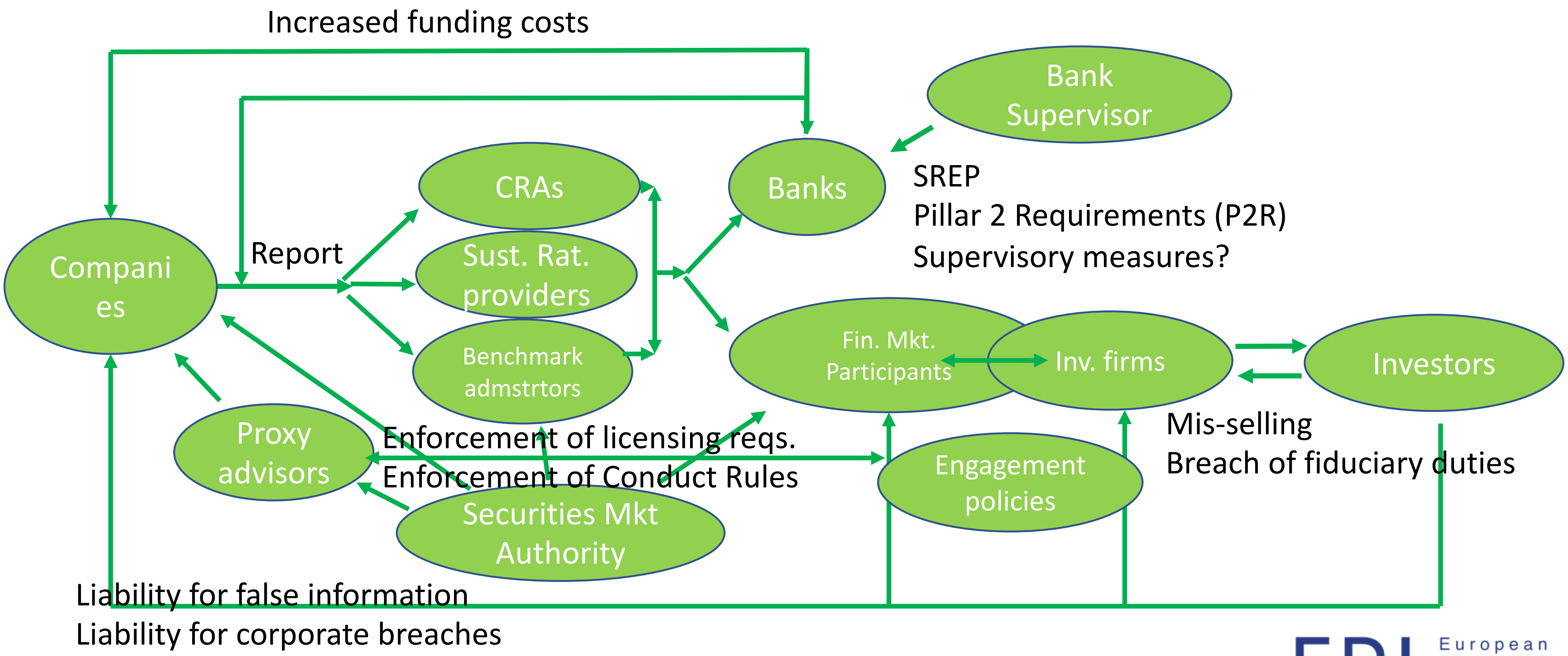
Voice-based strategy

- Added considerations
  - ‘Risk based’ and ‘impact based’ ratings are both important + **Ratings and benchmarks** should adapt to a **‘dynamic’ strategy** (where change is promoted from within) BUT
  - (1) Need of **consistency** across the chain + (2) Risk of **‘woolly’** information & **non-structured** discussion
- Concerns:
  - Ratings and benchmarks are **‘supply’**; **‘demand’** generated elsewhere (SFDR; MiFID; Banks’ Pillar 2)
  - **Little focus on ‘engagement’ policies** (Art. 4 (2) SFDR ‘Transparency of adverse sustainability impacts at entity level’; disclosure of ‘c) brief summaries of engagement policies in accordance with Article 3g of Directive 2007/36/EC, where aplicable)
  - **Benchmarks**: **mechanistic focus on ESG ‘governance’ & ‘compliance’ systems**: do not track change (not useful to foster engagement)
  - Rating providers: risks of subscriber-pays: quantity over quality & structure
  - **SREP**: Business Model Analysis – Risk Levels (RLs)
+
Governance, Risk Mgmnt – Risk Controls (RCs)
  - **Ratings are not adapted to this reality → Not useful to give supervisors leverage with P2G**
- **Focus on climate** may help improve structure

Exit, Voice & Penalty/Coercion



Exit, Voice & Penalty/Coercion



Penalty-based considerations

- Concerns:
  - Securities liability is not adjusted: **‘materiality’, ‘reliance’**
  - No enforcement of **‘licensing’** (**rating** providers are **unregulated**); **‘conduct rules’** cannot be enforced unless we know what they are supposed to achieve
  - No **liability for ‘opinions’** unless specific provision (e.g., Art. 35a CRAR… & actual harmonization is hard)
  - **P2R** need a robust basis (based on **probability of default**)
- Ways forward:
  - **Dynamic approach**: **exclusion** from benchmark or rating downgrade can support **materiality** claim + **reliance** admits nuances in the EU (Case C-910/19 *Bankia*) + **due diligence** duties connects sustainability and corporate duties
  - If **‘ratings’** become a **regulated subset of ‘data products’**, licensing and conduct rules can be enforced
  - **Ratings** can link *some* **ESG variables with bank-like risks**
  - **Focus on climate** information can help these aspects

Conclusions

- Diagnosis
  - The market of ESG ratings and benchmarks is **growing much**, **concentrated** but is **malfunctioning** (opacity, lack of quality & structure, concentration)
  - Current approaches: **'exit-based' and 'investor-led'**. Acceptable (maybe?) for ESG, but **not for the climate transition**
  - **Voice**-based strategies: almost **absent**. Ratings & benchmarks will react if rules create demand
  - **Penalty/Coercion**-based: **unthinkable** unless **more clarity** is achieved
- Some remedies:
  - Distinctions (core-periphery):
    - **Critical v. relevant information**
    - **Climate as 'core'** information, assimilable to financial information; other ESG factors: investor-led, light-touch, iterative
  - Benchmarks follow this logic: critical, significant/ general benchmarks – climate-based benchmarks
  - For 'ESG ratings'?
    - ESG data providers must comply with very basic registration & disclosure requirements
    - **'Ratings'** as a **subset** of products subject to **more stringent requirements** (licensing, conduct of business)
    - **Climate risk ratings**: minimum requirements (methodology), **link with 'normal' ratings** & banks' risk assessment