Core Positions of the French and German
Insurance and Asset Management Industry
on the EU Commission's proposal for a regulation of ESG rating activities

We welcome the proposal by the European Commission for a regulation on the transparency and integrity of Environmental, Social and Governance (ESG) rating activities. The planned introduction of regulatory standards for ESG rating agencies and their rating activities appears suitable in general to improve the quality of information on ESG ratings and to address existing shortcomings in the ESG rating market. We support in particular:

- Proposals to improve the transparency of ESG ratings particularly regarding objectives, characteristics, methodologies, and data sources used, while preserving methodological freedom
- The disclosure of whether the rating addresses double or simple materiality
- Increased clarity on the activities of ESG ratings providers and the requirements to avoid and mitigate risks arising from conflicts of interest among providers
- Provision of a clear and transparent complaints-handling mechanism
- A harmonised authorisation and supervision regime by ESMA for providers
- Proposal for fair, reasonable, transparent and cost-based fees and that ESMA will be allowed to take action in case of violations

However, to ensure the success of this initiative, we believe it is necessary to broaden the scope, to clarify some important issues and to further adapt some proposed regulations:

1) Inclusion of ESG raw data and other ESG data products in the scope of the regulation

Reliable and comparable ESG data is a prerequisite for the proper functioning of the European sustainable finance market in a similar way as ESG ratings. For many investors and providers of financial products ESG raw data and other ESG data products (hereafter collectively referred to as "ESG data products") play an even more important role than ESG ratings. There is a high demand for reliable and comparable ESG data, due to regulatory reporting requirements for financial market participants under SFDR (e. g. PAI) and EU-Taxonomy, but also for proper implementation of sustainable investment strategies and management of sustainability risks. Even though CSRD and the implementing ESRS will enhance availability and reliability of ESG data for EU issuers, significant data gaps will remain with regard to non-EU companies. ESG data vendors refer to different means for obtaining company-related ESG data, including extrapolations, approximations or estimations where the methodological approaches will remain unclear for the data users without regulation. The scope of the regulation should therefore also include provision of ESG data products.

Regarding ESG data (products) we see similar shortcomings as with ESG ratings. We are particularly critical of the lack of common standards and binding requirements, which limit the quality of such data. The current lack of transparency and reliability of ESG data not only weakens users' confidence in the accuracy of the data but increases their risk of being subject

to greenwashing allegations. Better comparability and higher reliability, as envisaged for ESG ratings, is therefore also needed for other ESG data products than ESG ratings.

In its November 2021 report[1], IOSCO recommends the supervision not only of ESG rating providers, but also of ESG data products and their providers and supports the idea of a regulatory framework for both.

In order to enhance their trustworthiness and comparability, ESG data products should fall within the scope of the Regulation in the same way as ESG ratings. As ESG data is usually collected and processed by ESG rating providers, the regulation on ESG ratings is a suitable regulatory framework. Its requirements for ESG rating providers and their products could serve as a blueprint for the regulation of ESG data products so that they are subject to similar requirements, in particular with regard to transparency, fees and the avoidance or mitigation of conflicts of interest.

Recommended points for action:

The suggested extension of the scope of the regulation to ESG data products should be accomplished by the following measures:

- Adaptation of Article 2(1) and deletion of the exemption in Article 2(2)(c)

- Inclusion of the respective definition contained in the IOSCO Report in Article 3 that should be supplemented as follows:

  "ESG data products": refer to the broad spectrum of data products, including estimates, that are marketed as providing either a specific E, S, or G focus or a holistic ESG focus on an entity, financial instrument, product or company's ESG profile or characteristics or exposure to ESG, climatic or environmental risks or impact on society and the environment, whether or not they are explicitly labelled as "ESG data products".

  According to its report IOSCO understands ESG raw data as one type of ESG data products. To avoid misunderstandings, it should be clarified that the definition of ESG data products includes ESG raw data.

- Extension of specific obligations under the proposed Regulation, in particular transparency requirements (Article 21) and complaints-handling mechanisms (Article 18) to the provision of ESG data products.

2) Clarification for ESG ratings produced by regulated financial undertakings (article 2(2)(b))

We welcome the exclusion of "ESG ratings produced by regulated financial undertakings in the Union that are used for internal purposes or for providing in-house financial services and products" as financial undertakings are already subject to robust requirements under the sustainable finance framework (i.e. SFDR, EU Taxonomy,…) and sector-specific conduct rules (such as conflict of interest management).

[1] IOSCO Final Report on Environmental, Social and Governance (ESG) Ratings and Data Products Provider

However, this article raises some questions with regards the disclosure of some elements under the SFDR that may be also captured by the ESG ratings regulation. Indeed, under the SFDR, financial market participants need to publish in their precontractual, periodic and website some information on financial products and notably the sustainable investment percentage. This sustainable investment percentage is based on each financial market participant methodology, is not provided for internal purpose (as it is published on financial products documentation) and could then fall under the ESG rating regulation.
Yet, the SFDR provides with several supervisory requirements. In this context, we believe that article 2(2)(b) should be clarified to exclude from the scope of the regulation any rating that could be provided by financial market participants as they are already covered by other pieces of regulation.
Finally, we believe that the internal use of ESG ratings should be extended to also capture intra-group exchanges of ESG ratings.

Proposed amendment: Article 2(2)(b):

"*ESG ratings produced by regulated financial undertakings in the Union that are:*

- *used for internal purposes or for providing ~~in-house~~ financial services and products,* ***or***
- *required by other EU regulations applicable to regulated financial undertakings, services or products,* ***or***
- *provided to other entities of the same group."*

Marketed activities: The proposal should clarify that only marketed activities are in the scope of the regulation. ESG ratings that are made available to the public without a commercial interest should not fall within the scope of the regulation.

3) Definitions of the proposed Article 3 should be clarified

The definition of ESG rating remains unclear. See Article 3: '*ESG rating' means an opinion, a score or a combination of both, regarding an entity, a financial instrument, a financial product, or an undertaking's ESG profile or characteristics or exposure to ESG risks or the impact on people, society and the environment, that are based on an established methodology and defined ranking system of rating categories and that are provided to third parties, irrespective of whether such ESG rating is explicitly labelled as 'rating' or 'ESG score'.*
The future regulation must spell out and define what is meant by 'opinion', 'score' and 'ranking system.' Otherwise, this may lead to different interpretation and application standards in practice.

Financial products: The European Commission proposal lacks a clear definition of financial products. It only provides that where an ESG rating relates to a financial product, the ESG rating provider must meet the regulation's requirements, without defining financial products. We suggest that the proposed regulation explicitly define financial products in Article 3 to eliminate any ambiguity.

4) Include the entire group of the ESG rating provider in the regulation

In order to discourage anti-competitive behavior and to avoid circumvention situations such as those observed today in the credit rating industry, it is crucial to ensure that the regulation on ESG rating activities does not provide any loopholes. Therefore, it will be particularly important to include the whole group of the ESG rating agency - including all subsidiaries - in the

regulation and to ensure that there are no circumvention possibilities in the involvement of third parties, in particular in the dissemination of ESG ratings and ESG data via licensing agreements with unregulated group companies. The Regulation must e. g. ensure that the requirements for ESG ratings, such as the disclosures according to Annex III, point 2, are also met in these cases and that the pricing requirements under Article 25 are complied with.
In order to avoid major distortions of the existing business models, the group-wide application should not apply to the separation of activities under Article 15.

Furthermore, the proposal excludes ESG ratings that are used for internal purposes or for providing in-house financial services and products. Such internal use should also be extended to intra-group exchanges of ESG ratings (cf. our requests under point 2 above).

5) Cost based fees and licence transparency requirement

We welcome the EC proposal for fair, reasonable, transparent and cost-based fees, but see the need for further specification. Currently, some major providers are not transparent on their fee grids, while others are and apply good practices. Furthermore, users of ESG ratings struggle with the licensing terms dictated by ESG rating providers. These apply to any ESG evaluation that is based even to a small extent on the purchased ESG rating and generally limit the use of ESG ratings as follows:

- no disclosure of ratings at the product/portfolio level
- no public dashboards on the website
- no provision of ESG-based exclusion lists to other third parties (such as asset managers acting as insources)
- no disclosure of ESG data even for regulatory KPIs at product/portfolio level
- no use for indexes

This leads to a lack of acceptance of ESG approaches because clients of users of ESG rating providers do not find sufficient information on the ESG assessment of their financial products (such as portfolios). Better transparency of licensing policies is thus urgently needed.

Therefore, we suggest adding the following to Annex III of the EC proposal under either point 2 which contains the detailed information that is to be disclosed to users or point 1 which contains the general list (publication on the website):

> *" - information on data pricing and license policies, including price lists, applicable to the users to which they market their ESG data product or rating services."*

In this context, it is currently not clear whether the information to users mentioned in Annex III, point 2, should only be made transparent in the ESAP from 2028 by reference to Article 13 – this would then be rather counterproductive. At least Article 22 (1) of the draft regulation assumes separate transparency towards users. If necessary, the reference from Art. 13 to Art. 22 (1) in Annex III, point 2, would need to be changed.

6) Rules for third-country providers should be feasible.

The **rules for market access by third country providers must not lead to a limitation of the ESG rating available to EU FMPs**. As it stands, the proposed approach in Article 9 of the EC proposal based on equivalence decisions will be futile, given that the largest ESG rating providers are based in the US where there is so far no intent to introduce comparable rules for

registration/authorisation of ESG rating providers. The only viable option would be the endorsement procedure which, however, would apply only to non-EU ESG rating providers having subsidiaries in the EU (cf. Article 10 of the EC proposal). No provider will really be able to benefit from the exemptions for small third-country providers because they will regularly exceed the thresholds (annual net turnover of less than EUR 12 million, cf. Article 11 of the EC proposal). However, the conditions for the proposed endorsement procedure are extremely strict, requiring de-facto equivalence ('requirements which are at least as stringent as the requirements of this Regulation') and setting up monitoring/oversight structures in the EU. The proposal provides for the possibility that ESMA may consider that compliance with IOSCO recommendations is equivalent to compliance with the requirements of this regulation for endorsement (art. 10(1) – 'ESMA may consider…') or for recognition (art 11(2) despite a wording that is unclear, and with an independent assessment). However: (i) IOSCO recommendations are unlikely to be 'as stringent as the requirements of this regulation' and may not reflect some characteristics that the EU would want to push forward. Typically, IOSCO will not insist on detailing whether the rating is considering double materiality. And most importantly IOSCO's requirements are not as granular as this proposed regulation (and possible RTS detailing Annexes). Therefore ESMA 'may take into account' whether the endorsed or recognized entity is already applying IOSCO recommendations, but it shall not consider it is fully equivalent. The assessment by ESMA should only be based on compliance with the EU rules themselves. (ii) Most importantly, this raises level playing field issues. EU firms would have to comply with the EU regulation while non-EU firms that are endorsed or recognized would have to comply to IOSCO recommendations (which are more flexible) only. This would not foster the emergence of EU market players (i.e., domiciled and operating in the EU) in a market where major players are actually non-EU. (iii) It should also be made clear that the threshold for recognition should be assessed on an aggregated basis to avoid circumvention within a group encompassing more than one recognized entity and/or by outsourcing to other entities of that group.

We urge the Commission to reconsider the endorsement procedure in order to ensure feasibility and to avoid an outcome in parallel to the Benchmark Regulation where the transition period for third country benchmark has just been extended due to the providers not willing to apply for recognition or endorsement under the EU regime.

In any case, the implementation deadlines and transitional periods should be chosen in such a way that it is realistically possible for EU and Non-EU agencies to set up the necessary legal organisational structures. The transitional periods currently envisaged in the draft appear to be very short for this purpose and may need to be adjusted.

7) Separation of business and activities

We are also critical of the proposal on the independence of ESG rating providers from the benchmark business as proposed under Article 15 of the EC proposal when providers covering each activity belong to the same group. In our view, in order to avoid major distortions of the existing business models, the group-wide application should not apply to the separation of activities under Article 15. This could lead to an increasing of pricings for users because these providers would have to adapt their current corporate structures and thus pass on the costs incurred for this to users. The proposal should be amended in such a way that ESG rating services and benchmarks services could be provided on a group level.

8) Disclosure requirements

We welcome the suggested proposals to increase transparency of the rating methodologies and data sources used, including disclosure of any limitations or use of estimates. The now envisaged comprehensive disclosure requirements will contribute to increased transparency, enhance comparability and competition in the market and would thus be an effective approach to address existing challenges in this context both from a user and rated company perspective.

Article 22 (1) regulates disclosure requirements, referring to the requirements set out in Annex III No. 2. Regarding the addressee of the information to be disclosed according to Annex III No. 2 it is important that this information is not only received by the rated entity or subscribers, as set out in Article 22 (1), but more importantly also reaches the users of the ratings, e. g. institutional investors or financial institutions. The disclosure obligations must apply in full, regardless of whether the user receives the rating directly from the ESG rating agency, an affiliated company or a third party. While Annex III correctly speaks of disclosure to users, Article 22 (1) refers only to subscribers. In order to avoid misunderstandings, we propose to clarify Article 22 (1) accordingly by replacing the word ‘subscriber’ with the word ‘user’.

9) Requests of information

According to Art. 30, ESMA is authorized to obtain the information necessary for the exercise of its supervision not only from ESG rating providers but also from third parties. Since according to Art. 30 (2) e) there shall be no obligation to actually provide the requested information, we see a potential risk of circumvention or business misconduct. It is important that the ESG rating agency remains responsible for the requested information in any case and that there is an obligation to provide information for the group companies involved.

10) Significance for the regulation of credit rating agencies

Now that a draft has been presented with the ESG Rating Regulation that appears suitable for eliminating major deficits in the ESG rating market and at the same time attempts to avoid errors of the CRA Regulation (e. g. through proposals on data and methodological transparency, as well as requirements on invoiced costs), we believe that in due course also the CRA Regulation should be reviewed again to correct corresponding mistakes.

5. October 2023