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Opinion of the European Financial Congress[1] in relation to the European Commission's request for feedback regarding the proposal for regulation on the transparency and integrity of Environmental, Social and Governance(ESG) rating activities [2]

Opinion development methodology

The EFC opinion has been prepared in four steps.

Step 1

Based on the European Commission's material, the European Financial Congress (EFC) prepared an abbreviated material with four consultation questions which the EFC considered to be of key importance. The questions are as follows:

- Could RTS become an excessive barrier to ESG rating agencies?
- Should different methodological approaches be considered and introduced for different sizes of ESG ranking applicants?
- Is there a real risk of increased costs for assigning ESG ratings and traditional ESG-sensitive credit ratings in the absence of unified data collection rules and methodologies for both types of ratings? Are efforts to standardize such measures desirable?
- Is the demand to separate ESG rating from other rating activities (to minimize the problem of conflict of interest) in such a way that these activities are not combined justified? If so, how to separate such activities?

Step 2

A group of experts from the Polish financial sector were invited to participate in the survey. They were asked to read the original proposal of the EC and provide response to the four EFC questions. The experts were guaranteed anonymity.

[1] The goal of the European Financial Congress (www.efcongress.com) is to engage in debate on the security and stability of the financial systems of the European Union and Poland. The EFC is run by the Centrum Myśli Strategicznych.

[2] https://ec.europa.eu/info/law/better-regulation/have-your-say/initiatives/13330-Sustainable-finance-environmental-social-and-governance-ratings-and-sustainability-risks-in-credit-ratings_en

Step 3

The European Financial Congress received 20 opinions from

- Commercial banks
- Investment funds
- Regulatory authorities
- Consultancy companies
- Rating agencies
- Academics.

Step 4

Based on the responses obtained, the survey's coordinator developed a proposal for a summary position of the European Financial Congress. This proposal was presented to the experts participating in the survey . They were asked to make adjustments, if necessary. The final version of the responses was translated into English and submitted to the EC.

Feedback by the European Financial Congress

Regardless of the overall positive opinion on this project, its purpose, form and expected effects, the European Financial Congress experts pointed out several risks associated with the introduced regulation and several proposed solutions.

The proposed regulation will be implemented in practice using the RTS that will be adopted by ESMA in the future, including such important ones as those concerning the forms of applications for registration, or the methodology on the basis of which ESG ratings will be assigned. These RTS will also be crucial to the cost of operating the ESG rating system for both the rating institution and the entity obtaining the rating (the issuer, or financial instrument). The question of whether this may cause excessive barriers to entry into the rating agencies market cannot be answered conclusively, as the details of the RTS are not known. However, it should be emphasized that the current ESG ratings market is not functioning properly, trust in ratings is being undermined, and current ESG ratings do not serve their purpose and do not sufficiently enable users, investors and rated entities to make informed decisions regarding ESG risks, impacts and opportunities.

The introduction of this regulation along with the RTS should promote greater transparency with regard to ESG rating methodologies, or the conduct of ESG rating providers. Could RTS introduce an excessive barrier to entry? It seems that such a risk is relatively low, as ESMA will consider costs and benefits before developing draft implementing technical standards. Smaller rating agencies may find it difficult to comply with these standards, which may hinder their operations and ensure competition in the market especially in the first period after the introduction of the regulation. The solution may be to introduce/adjust the requirements to the size of the rating agency, thus differentiating between large and small ESG rating providers, e.g. in a similar way as it was organized in the regime of Regulation 1060/2009 on credit rating agencies (CRA).

In our view, the regulation should not directly interfere with the rating methodology used by rating agencies. The draft regulation does not (and rightly so) specify the type of methodology or model that can be used for ESG ratings. Providers of ESG ratings will retain full control over the methodologies they use and will continue to be independent in their choice of methodologies, ensuring the availability of different approaches in the ESG ratings market (i.e., ESG ratings may differ from one another and cover different areas, or entities).

This raises the question of whether a different methodological approach for different sizes of ESG rating applicants is necessary and reasonable, so as not to create a barrier for rating applicants, in case the cost of obtaining a rating is too high for small entities to apply for. This may also exacerbate the phenomenon of green huffing.

In principle, all entities subject to ratings should be subject to the same methodological approach, as one of the goals of the proposed regulation is to achieve a better level of comparability.

In order not to create undue barriers for small entities, potential modifications to methodologies should be allowed given the scale and characteristics of the ESG rating applicant's business. It is reasonable to vary the level of fees for the provision of ESG rating services depending on the size of the entity. At the same time, modifications should be controlled and standardized. It is clearly not advisable to use completely individual methodologies for different clients.

Another important issue is the linkage between the assignment of ESG ratings and traditional ESG-sensitive credit ratings in the absence of standardized data collection rules and methodologies for both types of ratings and possible efforts to standardize such efforts.

Both the lack of introduction of uniform ESG standards and their introduction will result in increased costs, while the difference may be that costs in the absence of uniform rules will steadily increase, while with standardized methodologies they will be higher at the beginning, but in the long term should result in savings with the development of appropriate tools. With the passage of time and the development of new ESG reporting obligations, savings will also be realizable through better and widespread access to non-financial data of assessed entities. However, we do not see the need or possibility for detailed standardization of methodologies for ESG ratings and ESG-sensitive credit ratings.

Currently, the problem of ESG data availability is a key barrier for ESG rating agencies as well as financial institutions. Harmonization of data collection rules in the form of, among others, ESG data hubs created at the national or EU level (e.g. ESAP, OeKB project in Austria, Impact project in France) and the standardization of the format of shared data (known as iXBRL) will significantly increase access to data and ability to process them. This may lead, in market practice, to a reduction in rating costs and to competition in the rating agency market.

Another important issue for the market is the problem of potential conflicts of interest and the possible separation of ESG rating from other rating activities.

In principle, we have no objection to the proposed separation of ESG rating activities from other rating activities (Article 15 of the draft ESG Ratings Regulation- 2023/0177 (COD)). As a rule, the ESG ratings should be issued by separate, independent entities/legal entities.

The potential conflict of interest in assigning ratings in principle exists between the issuer or rated company and the rating agency (a problem when "the issuer pays").

However, we see no rationale in separating the assignment of ESG ratings from credit ratings. Both ESG ratings and credit ratings are intended to help investors make investment choices tailored to their strategies and risk appetite. In addition, credit rating agencies already have methodologies and techniques developed over the years to determine ratings, and thus their experience can enhance the reliability and credibility of ESG ratings. Therefore, we do not see a risk of conflict of interest in the event that one entity produces ESG ratings and credit ratings.

At the level of credit decisions within the agency, the separation of rating committees - ESG separateed from credit - may be worth considering.

An additional solution could be a forced rotation mechanism for rating agencies. The practice of the credit rating market shows that rating agencies traditionally establish long-term relationships with rated entities. This results in the risk of excessive intimacy. In order to increase competition in the market, measures should be taken to encourage the use of smaller rating agencies.

On the other hand, we see the need to regulate conflicts of interest related to the rules for assigning ESG ratings based on publicly available data. Market practice indicates situations when ESG ratings are assigned based on an overly cursory assessment that is intended to "encourage" the rated company to enter into a contract with an agency for a paid rating. It should be assessed as a reprehensible phenomenon when there is a significant improvement in the ESG rating/assessment at the time of "transition" from a free rating to a paid rating.

In our opinion, the draft should regulate the issue and introduce solutions to the problem of ratings issued without contact with the rated entity, when the agency does not even inform the rated entity that it has proceeded with its evaluation. It is necessary for the agency to ensure that it has all the information to reliably and fairly assess such an entity. Some entities do not have to disclose all their activities regarding the ESG area. The agency's obligation to directly obtain data and information from the entity should be considered.