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AFG response to ESMA call for evidence on Market Characteristics for ESG rating providers in the EU

AFG

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The AFG federates the asset management industry for 60 years, serving investors and the economy. It is the collective voice of its members, the asset management companies, whether they are entrepreneurs or subsidiaries of banking or insurance groups, French or foreigners. In France, the asset management industry comprises 680 management companies, with €4355 billion under management and 85,000 jobs, including 26,000 jobs in management companies.

The AFG commits to the growth of the asset management industry, brings out solutions that benefit all players in its ecosystem and makes the industry shine and develop in France, Europe and beyond, in the interests of all. The AFG is fully invested to the future.

6.2.4. GENERAL VIEWS ON ESG RATINGS IN EU FINANCIAL MARKETS

Question 1: Please provide your views on the level of relevance of ESG ratings to EU financial markets and financial market participants. Do you consider this level will increase in the coming years.

The sustainable finance regulation and the increasing interest of investors and market participants to incorporate ESG factors into their decision making has been one of the major trends in recent years. ESG themes also become an EU regulatory subject, making the data issue even more acute. The sustainable framework not being finalized, market participants rely essentially on data providers to make informed investment decisions and to comply with the regulation requirements.

In the current state of the legislation, some challenges need to be addressed:

- **Non-financial information is not always available**: there is no or little constraint for companies to disclose such information.
- When data is available it is **not standardized.**
- **Methodologies** on some ESG aspects **are still being developed** and are subject to changes.
- There is a **lack of harmonisation around key indicators** (e.g. scope 3 and avoiding double counting at the portfolio aggregation level) **and methodologies** for market participants.
- There is no public/free database where investors and public can access raw ESG data from issuers (raw: unbundled from analysis).

All these challenges make it difficult to have a comprehensive, reliable, and comparable framework on ESG data.

With regards ESG data and rating providers, if asset managers recognise the value added of ESG data and rating providers, AFG strongly think they should be regulated, and become more transparent, as the use of their ratings faces lots of challenges.
They have developed **internal scoring methodologies that do not include the same factors on E, S and G pillar**. They measure, weight and score company sustainability risk and performance in different ways. This results in companies having different ratings depending on the ESG rating provider, often leading to orthogonal results. The dispersion in ESG ratings is very high, while the dispersion in credit ratings for a same issue/company is very low.
Moreover, **data and rating providers can also change methodologies from year to year** making historical comparisons difficult (is the variation of ESG rating due to the company progress, the change in methodology or both?).
The opacity behind methodologies makes it difficult to understand variation in ESG ratings.

It is also important to note that there is a **heterogeneous coverage of companies** with a satisfactory score for large capitalisations and companies from developed countries, but data is lacking in other areas. Cultural specificities also generate a bias depending on the provider nationality and ESG philosophy which does not help when dealing with raw data.
Finally, ESG data and rating providers have inherent conflicts of interest (particularly with providers both evaluating companies and offering paid advisory services).
These bias and the variation that occurs across methodologies contribute to weak correlation (and high divergence) across scores from different rating companies.
We believe that the reliability of ESG ratings tends to improve in the coming years due to:

- The **implementation of the CSRD** whose objective is to address problems in the comparability, consistency and relevance of sustainability information disclosed by companies. The CSRD will harmonize non-financial reporting and will require an audit of the information, ESG data will then be comparable and reliable.
- The **upcoming ESAP** for EU financial and non-financial data that will allow an access to reliable, comparable, and audited non-financial data.

We believe that other steps should be implemented to increase this reliability, **the EU should create a holistic regulatory framework for data and rating providers** (for both financial and non-financial information). In addition, a similar approach to the one applied to the proxy advisor industry, with a code of conduct, a comply or explain approach and an Independent Oversight Committee should be implemented.
This framework **should focus on increasing data and rating providers'**:
- **Transparency on the methodologies used as well as how data is obtained and verified**: the fact that an ESG rating differs from another on a same issuer is not per say problematic if it can be explained by different methodologies.
- **Transparency regarding data fees**. Requirements on the matter could draw on the fair, reasonable, non-discriminatory and transparent principle already existing in the EMIR Regulation.
- **Accountability requirements** tackling notably conflict of interests and market abuses (code of conduct and best practices).
- **Dialogue with rated companies.**

An Independent Oversight Committee should be implemented to provide the market with independent assurance that data and rating providers are meeting agreed best practices, serving the interests of their customers while treating issuers and other stakeholders fairly, with accuracy, integrity, and responsiveness.

Finally, an equivalence regime for non-EU data providers should also be implemented (cf. Q2 for further details on non-EU data providers).

Question 2: Please provide your views on the level of risk ESG ratings currently pose to orderly markets, financial stability and investor protection in the EU. Do you consider this level will increase in the coming years.

The challenges identified (please refer to Q1 for the list of challenges) could lead at some point to the perception of a "greenwashing" risk.

Other risks were also identified:
- **Arbitrage** due to ESG ratings variation among data providers.
- **Misleading investors** due to fragmented data availability, lack of transparency with regards methodologies and a lack of contextualized information. Indeed, a company could be rewarded only because its coverage rate is higher or because the company discloses more ESG information, even if its ESG practices are weak.
- **Conflicts of interest**: when data providers are both evaluating companies and offering paid advisory services.

- **Financial products with higher prices:** data fees from providers being reflected in the financial product price. This risk is higher with the use of ESG data for regulatory purposes (compliance with the EU sustainable finance regulation and reporting).

In order to ease the transition towards a more sustainable economy, **ESG data is as much important as financial data to assess a company**. It is a very powerful tool to better understand the companies' asset managers invest in. As such, **ESG data should face the same level of requirements as financial data**. Hence, **ESG data should be audited by a third-party**.

Finally, it should be highlighted that provision of ESG data in the EU depends on an oligopoly of – mainly non-EU data providers. This situation places EU market participants in a weak and captive position for gathering the requested ESG data to comply with the EU regulation. The absence of EU authorisation and even localisation requirements for data providers providing financial and non-financial data to European users is **concerning for the EU's sovereignty, notably in relation to the European Commission' Strategy for financing the transition to a sustainable economy**. We believe that, as part of a future framework for data providers, **the introduction of an equivalence regime for third-countries data providers would make sense and preserve EU competitiveness and sovereignty.**

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