HOW TO STOP THE WILD GREEN GOLD RUSH: CREDIBLE ESG RATINGS

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EXECUTIVE SUMMARY

- The market for environmental, social and governance (ESG) rating and data is expected to grow immensely in the next decades. This brief zooms in both on the integration of ESG risks into “traditional” operations of Credit Rating Agencies (CRAs) as well as on the emergence of a market exclusively dedicated to ESG rating. As will become clear, the market for ESG ratings suffers from serious shortcomings, a lack of transparency and standardisation, significant biases and conflicts of interests, and a dependence on large, oligopolistic, credit rating agencies.

- Regulation is needed to address these issues, but regulators must be careful to avoid making policy even more reliant on a nascent market. Specifically, **regulation is required to increase the accuracy, transparency, neutrality, and objectivity of ESG ratings, as well as the scrutiny and enforceability capabilities of regulators.** Regulators should therefore develop minimum standards for the labelling and certification of ESG ratings. They should also call for ESG rating providers to use transparency standards in their methodologies. The ESG regulation should be adapted to the size and market relevance of ESG rating providers, in order to create a competitive and innovative market for ESG rating data.

- In the meantime, we argue that **those who use ESG ratings, specifically the European Central Bank, should not become excessively reliant on external rating agencies in their climate action**. The ECB’s own research findings highlighted a lack of transparency in the methodology used by ESG data providers. The Bank called for increased regulation and made several recommendations regarding transparency and disclosure requirements (Breitenstein et al. 2022). As such, the ECB should develop its own benchmarks that apply both to its monetary and prudential arms.

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LIST OF ABBREVIATIONS

CRA	Credit Rating Agency
EC	European Commission
ECAI	External Credit Assessment Institution
ECAF	Eurosystem Credit Assessment Framework
EBA	European Banking Authority
ECB	European Central Bank
EIOPA	European Insurance and Occupational Pensions Authority
ESA	European Supervisory Authorities
ESG	Environmental, Social, and Governance
ESMA	European Securities and Markets Authority
EU	European Union
HQLA	High Quality Liquid Assets
ILO	International Labour Organization
IOSCO	International Organization of Securities Corporations
PAB	Paris-Aligned Benchmark
SFDR	Sustainable Finance Disclosure Regulation

1. INTRODUCTION

Environmental, Social, and Governance (ESG) ratings (and ESG rating providers) have become a hotly debated topic within the financial sector and among regulators. On the one hand, there is a perceived need among many stakeholders to make finance accountable for its impacts on the environment and society. Measuring how ESG factors affect companies and financial products is one important element towards a more sustainable financial and economic system. On the other hand, concerns have been raised about the capacity of ESG credit ratings to effectively "green" the financial sector. As this report will argue, the current unregulated state of the ESG market, and the tendency of public actors, such as the ECB, to delegate rating processes to private external actors, call for caution.

There is no universally accepted method of defining what ESG ratings actually are. Broadly speaking, there are two types of ratings which take ESG factors into account (IOSCO 2021).

First, ESG credit ratings (or ESG risk ratings) aim to evaluate how environmental, social, and governance (ESG) factors affect the creditworthiness of an asset or a firm (that is, its risk of default). Indeed, including ESG risks in the evaluation of an asset is important for asset managers and institutional investors, who analyse how these factors affect the creditworthiness of their portfolio. It is also highly relevant for society as a whole, as taking ESG risks into account constitutes a necessary step towards a more sustainable financial system.

Second, for the general public, ESG ratings have also come to mean measures of the Environmental, Social, and Governance impacts of firms, known as ESG impact ratings. Nevertheless, most CRAs now exclusively produce ESG credit ratings and not an assessment of a firm's actual ESG impact. Confusion between the two meanings creates severe risks of greenwashing, for, as we will see, a firm with a "good" ESG credit rating does not necessarily also have a "positive" impact on the environment or society. In this paper, we will mainly focus on ESG credit ratings, for they have attracted much attention in the literature and account for the lion's share of the ratings being produced. We will clearly indicate when we consider the second meaning (ESG impact ratings).

The market for ESG data is growing at a steady pace, and, in 2019, it was estimated that spending on ESG data was close to $617 million (EC 2020, 7). **Regulators should step in so that the push towards a greener economy and a more sustainable financial system does not turn into a wild "green gold rush"** which would only bring immense profits to rating agencies and increased greenwashing opportunities for investors and the wider financial system, but without any benefits to society.

As this report will make clear, **ESG ratings, and the agencies responsible for producing them, are a work in progress that still suffer from a number of issues.** Most notably, these are a lack of transparency and standardisation, significant biases and conflicts of interests, and a dependence on large, oligopolistic, credit rating agencies, most of which are not head-quartered in the EU.

Section 2 reviews these issues, some of which are not unique to ESG ratings, but the legacy of a long history of deregulation and over-reliance on credit rating agencies. Section 3 focuses on the use of ESG data by the European Central Bank (ECB) both in their monetary and prudential arms, and argues that **the ECB should not become excessively reliant on external rating agencies, but rather develop its own benchmarks.** Finally, section 4 reviews the current state of regulation, and shows how it is lacking both in consistency and in ambition.

Given the scale of the problems, and the need for regulation, we end our report with a series of recommendations. **We argue that regulation is needed to increase the accuracy, transparency, neutrality, and objectivity of ESG ratings**. Regulators should therefore develop minimum standards for ESG labelling and certification, in line with the aims set by the Paris Agreement. They should also demand that the methodologies used by ESG data providers comply with higher transparency standards, and make full transparency on methodology mandatory for their client as well as for regulators. Supervisory authorities should be empowered to access all relevant information needed to assess the compliance of ESG providers and ESG data with EU legislation. Finally, ESG regulation should be adapted to the size and market relevance of ESG rating providers, in order to create a competitive and innovative market for ESG data.

2. WHAT'S WRONG WITH ESG CREDIT RATINGS?

ESG credit ratings, and ESG credit rating agencies, play an important role in closing the gap in the market for sustainability analysis and data provision. They have high potential in rallying the market towards sustainability and could play a role in mitigating climate change by providing much needed data and analysis to investors and the wider financial system. At the same time, in its current unregulated and nascent stage, controversies remain surrounding their ability to foster the transition towards a more sustainable financial system. This has ignited much debate among academics, policy makers, and central bankers. This section reviews the main issues pertaining to ESG credit ratings, and clarifies what improvements are required in order to make the financial system truly accountable for its environmental, social and governance impact on society.

The main point which stands out of this discussion is that **its users should be wary of relying excessively on ESG credit ratings. As will become clear below, the market currently suffers from serious biases, a lack of standardisation, and lack of transparency, among other problems, and is far from providing adequate information to guide policy**. Regulation is needed to address these issues, but regulators must be careful to avoid making policy even more reliant on a nascent market.

2.1 Conflicts of interest: the problematic legacy of CRAs

Even before the advent of ESG credit ratings, credit rating agencies (CRAs) were not exempt from problems (Rutledge and Litan 2014) including: lack of a transparent methodology, absence of a single public structured credit scale, blind faith of investors in ratings, and the oligopoly of the three main CRAs (the "Big-Three": S&P, Moody's, and Fitch). As we will see in the following sections, these problems have also become common with ESG credit ratings. One, however, stands out: the issuer-pays business model used by most CRAs, which has been blamed by some as one of the causes of the Global Financial Crisis (Neuman 2010).

The issuer-pays model is a business model in which the issuer of the rated product pays for the rating of its product (Whalen 2016). An obvious conflict of interest arises from this situation: on the one hand, the issuer will tend to choose the most lenient rate provider; on the other hand, the

rate provider has an interest in pleasing its client, and thus to provide the issuer with a generous rating (Whalen 2016, Neuman 2010). Consequently, there is a risk that ratings will not adhere to high standards of objectivity and neutrality.

The very same conflict of interest is also a serious issue for the many ESG credit rating agencies that also use the issuer-pays business model (though not all do). However, according to a recent report published by the European Commission (EC 2020, 69–71), the conflict generated by the issuer-pays business model is only one among the many plaguing ESG rating agencies and their clients. They also face (at least) four additional conflicts of interest.

The first concerns the ownership structure of CRAs. Some CRAs are owned by private equity firms which also own a portfolio of companies rated by the very same CRAs. In these cases, the private equity firm may have an interest in pressuring its own CRA to rate its portfolio companies positively.

A second conflict of interest emerges when a CRA provides rating services as well as services to companies to help them improve their rating. While the rating entity might have guidelines aiming to separate the rating team and the advisory team, there are no external checks available to verify their efficacy, partly because advisory services are not currently regulated in the EU.

A third conflict of interest relates to the internal organisation of some CRAs. The commercial part of the business may try to influence the research side by pushing them to give positive evaluations to their clients. Without hermetic separations between the commercial and the research sides of CRAs (the so-called “Chinese wall solution”), there is no guarantee of a fair and neutral evaluation of the credit risk or ESG potential of a client.

Finally, a fourth type of conflict of interest may arise if there are no checks and balances in place to control the work of the research team and avoid undue influence from external actors (such as asset managers). According to the European Commission report (EC 2020, 71–73), some CRAs are trying to mitigate this by setting up codes of conduct, but there is insufficient evidence to conclude whether they have been able to prevent misconduct.

2.2. Lack of standardisation and transparency in ESG

ESG ratings are everywhere, and their influence on financial decision-making and financial supervision has been growing steadily in recent years. Yet, as we have already argued in the introduction, **there is no agreed-upon vocabulary on what ESG or sustainability actually means, and no consistency of terms across products or service providers** (Doyle 2018, Breitenstein et al. 2022). According to a report by the EC, “no formalized naming structure exists across the market to describe sustainability related products and services, and providers utilize different terms in different ways.” (EC 2022, 31).

In particular, it should be noted that most ESG rating providers only provide data on the ESG risks associated with an asset or a firm. They thus produce ESG credit ratings, and, in this case, the “E” of “ESG” concerns how environmental risks affect a company’s (or an asset’s) creditworthiness. Some, usually smaller, ESG rating providers do take into account the ESG impact of firms or assets. However, such (rare) cases only contribute to the overall inconsistency of these ratings across the board.

There is thus not necessarily a correlation between ESG credit ratings and the actual environmental impact of companies (Larcker et al. 2022, OECD 2022). This raises major problems, as ESG credit ratings are often used as a proxy for the environmental and climate performance of companies.

This lack of structured and common language has been highlighted by numerous academic studies (Billio et al 2021, Kimbrough et al 2022, Escrig-Olmedo et al 2019, and Abhayawansa and Tyagi 2021). It is also a recurrent complaint among stakeholders (Doyle 2018). As exemplified by a recent consultation organised by the European Commission (EC 2022), there is consensus among credit raters, asset managers, and asset owners, that **a lack of standardisation is plaguing the market and damaging the credibility of credit rating agencies**. This lack of consistency and comparability among ESG ratings is made worse by the lack of transparency on the methodology of credit raters.

First, very few providers make their methodology available, and the full methodology is never available (EC 2020, 106-107). CRAs that provide ESG credit ratings have business reasons not to publish their methods, for this would endanger their business model. Yet, a lack of transparency makes regulators reliant on data they cannot control, and whose sources they cannot verify. Moreover, as Berg et al (2021) note, it is often difficult to know why the rating of a company has been upgraded or downgraded, for CRAs do not have to provide a justification or an explanation of their reasons for doing so.

Second, there is no detailed publicly available information on the data verification process, as most information is proprietary. In its assessment of ESG rating agencies, for instance, the EC noted that “we did not hear of any instance of providers using external verification processes for data quality” (EC 2022, 90).

Finally, the lack of transparency is aggravated by the lack of regulation of ESG raters, to which we will return in section 3 (see also Abhayawansa and Tyagi 2021). Because there is no specific regulation for ESG rating providers, they are not obliged to apply specific frameworks, such as the EU taxonomy. In fact, in its inquiry, the EC noted that none of the ESG credit providers they consulted explicitly declared which regulatory framework they applied, or even whether they followed one (EC 2020, 106).

The lack of transparency is a serious issue in its own right. It is also becoming an urgent issue for regulators and supervisors, which are increasingly relying on data which they must blindly trust. We will return to this issue in section 4, when discussing proposals for regulation.

2.3. Five biases of ESG credit ratings

The lack of standardisation and transparency, as well as the monopolistic tendencies of the ESG market described in the previous sections, exacerbate the risk of bias for ESG ratings. In line with the report published by the EC in 2020 (EC 2020, 111–118), this brief highlights five main biases.

Company Size Bias

There is evidence that larger companies tend to obtain higher ratings than smaller ones (Drempetic et al 2020; Giese et al 2019). One reason may be that they have greater ability to dedicate more resources to produce adequate financial and non-financial data, and to respond to investor surveys (Doyle 2018). Ideally, size should not matter.

Geographical Bias

The market for ESG credit ratings is also heavily biased in favour of companies headquartered in richer, developed, countries. One reason, pointed out by the EC study (EC 2020, 114), is that regulatory pressure is higher in these countries. Yet some differences in ESG ratings do not seem to be justified. For instance, Liang and Renneboog (2017) stress that ESG ratings tend to be more favourable for companies located in civil law countries compared to common law countries. They also noted that those located in Scandinavia are more favourably ranked, even when controlling for the regulatory environment and other intrinsic factors. Similarly, Doyle (2018) points out that companies domiciled in Europe generally receive much higher ratings than those located in the USA.

Industry Bias

Companies belonging to the same industry are very often evaluated under the same model, without taking into account individual differences (Doyle 2017). This may advantage (or disadvantage) (un)virtuous companies depending on the average state of ESG within an industry. There is, for instance, a bias against the extractive sector.

Company Engagement Bias

Like with any rating effort, there is a risk of bias when ESG rating companies engage with their clients to help them improve their ratings (Douglas et al 2017).

Language Bias

Finally, ESG rating agencies tend to “unduly favour companies reporting in the English language over companies that only report in local languages”, as noted in the EC report (2020, 118).

2.4. Lack of correlation

The lack of standardisation and the absence of transparency on the methodology of ESG raters do not only lead to significant biases. They also result in ESG companies producing very different ESG ratings for the same companies. In fact, statistical studies have shown that the rate of correlation between ESG ratings from different sources is very low (Berg et al. 2022; Kimbrough et al 2022). **Low correlation is a serious worry, for it signals deep disagreement among ESG raters as well as profound differences in methodologies.** This may also have several negative consequences for investors and companies.

First, investors relying on one single ESG rating will fail to track possible disagreement among ESG raters, and it may turn out that their investment decisions will be based on incorrect information. More fundamentally, they may simply choose the more lenient ESG rating, the one that just fits their needs, not the one that is giving a true picture.

Second, disagreement among ESG raters may prevent companies from improving their ESG performance, for they receive contradictory signals. Ideally, it should be the case that all ratings more or less flag the same information, for it is the nature of the assessed company that matters, not the methodology of the rater.

Low correlation has been recognized as a problem by many stakeholders (EC 2020, 123). Naturally, many stakeholders are questioning the credibility of sustainability-related ratings and highlight the lack of standardisation as a possible cause. Consequently, many express the need for greater transparency on methodologies, as well as a need for greater regulation, as highlighted by a consultation conducted by the EC in 2022 (EC 2022).

As we will argue in sections 3 and 4 below, one must be extremely cautious: sustainability legislation is very reliant on ESG ratings. Yet, the ESG market is still nascent and unstable, and needs to stabilise and develop before regulators could consider increasing their reliance on ESG rating agencies.

2.5. Greenwashing

Given the fast-expanding market for “green” products and investments, there is an increased incentive for financial institutions to label their products as “sustainable” and “responsible”. ESG rating providers are a potential pipeline to greenwashing claims.

To recall, most ESG ratings providers actually produce ESG credit ratings, which are meant to provide a measure of how ESG factors affect the credit risk of an asset or a firm. This means that an asset with a high ESG credit rating is not necessarily a “sustainable” asset with a “nature-positive” or “green” impact on society, but an asset with low ESG risks for the company or the investor. **Without adequate definitions of terms, standardisation of methodology and proper audit of ESG rating agencies, the scale of greenwashing and the adequate response to it are impossible to determine.** This applies both to intended and unintended cases of greenwashing. For the latter, even if the ESG product information is transparent, without clear minimum standards applicable across all providers, investors might simply overlook or fail to compare products across different rating providers. This could potentially lead to a proliferation of unintended greenwashing.

The European Commission is taking greenwashing risks seriously and is planning to put forward a legislative proposal dedicated to ESG ratings in June 2023.[1] In a similar move, and given the current lack of regulation, the European Supervisory Authorities (EBA, EIOPA and ESMA) have issued a call for evidence and are due to come up with a study on greenwashing by May 2023. Of the three ESAs, ESMA is tasked with identifying greenwashing issues related to CRAs and ESG data and providers.[2] The amplification and/or mitigation of greenwashing risks in the future are thus inseparable from ESG data and rating providers’ standardisation efforts.

1. See the tentative agenda of the EU Commission meetings.
2. See the call on ESMA website.

2.6. Lots of E, some S and very little G

Despite the fact that ESG credit ratings are supposed to reflect the environmental, social and governance risks that affect the creditworthiness of an asset or a firm, **most of the focus of policy makers and ESG rating agencies has been on the first component (E). Very little attention has been given to the other two (S&G).**

One reason may be that environmental concerns are politically more urgent and that their financial materiality is more visible than the other two. As an example, one could think of the recent EU taxonomy which only targets environmental issues, leaving behind much of the social and governance aspects of sustainability.[3] By contrast, work on an equivalent social taxonomy, launched in 2021, is lagging behind given the absence of significant political will (Allenbach-Ammann 2022), and despite the recent publication of a report for the European Commission by the Platform on Sustainable Finance (2022).

In addition, unpicking the different elements within a rating is made impossible by the lack of transparency regarding the methodology behind ESG credit ratings (Doyle 2018, Breitenstein et al. 2022). The relative weight of each aspect is often simply unknown to the public, the buyer of the rating and legislators. These groups cannot know how (or whether) the social and environmental aspects of ESG are taken into account, and how they relate to each other (EC 2020, 31). **The separate contribution of each element of the rating (E, S, and G) should be clearly stated for each firm/asset, and made available to clients and regulators.**

2.7. Dependence on large non-EU firms

A final issue concerns the state of market concentration in the European Union. **In recent years, much like the CRA market, the ESG market has tended towards a greater concentration in the hands of a few companies.** These companies are mainly headquartered in the US (Moody's, Fitch, and S&P) and have merged with or acquired smaller EU firms (EC 2020, 7-8; 33). According to a recent analysis by the EC, EU-headquarter ESG companies are generally much smaller in size than their US equivalents, and have a far lower market presence (EC 2020, 51 et sv). There is thus a high risk of oligopoly as well as a risk of dependence on non-EU actors, which may fall beyond the reach of EU laws or regulations.

3. See the website of the European Commission on the EU taxonomy.

3. USE OF ESG DATA IN MONETARY POLICY AND PRUDENTIAL SUPERVISION

ESG credit ratings are increasingly used by various public and private financial institutions. The case of the ECB is particularly interesting, for it uses ESG data both for monetary policy and prudential supervision purposes.

First, the ECB is reliant on CRAs and ESG ratings for the conduct of its monetary policy operations. The CRAs (also called "External Credit Assessment Institutions", or ECAIs by the ECB) have long constituted one of the three pillars on which the Eurosystem Credit Assessment Framework (ECAF) rests.[4] The ECB accepts only high-quality and low risk collateral in its monetary policy operations and the ECAIs have been tasked with assessing the credit quality of collateral. At the moment, there are four ECAIs that carry out this work: S&P, Moody's, Fitch, and DBRS Morningstar.

Integrating climate and environmental risks into collateral assessment has recently been described as one of the top priorities within the ECB climate roadmap (published in 2021).[5] Therefore, reliance on CRAs will likely increase in the future. How they assess ESG risk and integrate ESG data and methodology will have a significant and increasing impact on the monetary policy operations of the ECB.

Against this background, the ECB conducted a study that aimed to analyse how ESG factors are integrated into ECAIs (Breitenstein et al. 2022). Its findings highlight the lack of transparency of the methodology of ECAIs, as already echoed in the EC report (EC 2020). Its authors therefore call for increased regulation and make several recommendations regarding transparency and disclosure requirements (Breitenstein et al. 2022, 22-24). Calls for increased transparency have not yet led to legislative requirements, but change might be coming, as outlined in the next section.

Second, alongside the ECB's monetary policy operations, credit ratings are also being used within the prudential regulation and supervision framework

4. The two other pillars are the national central banks' in-house credit assessment systems (ICAS) and the counterparties' internal ratings-based (IRB) systems. See the ECB website.

5. See https://www.ecb.europa.eu/press/pr/date/2021/html/ecb.pr210708_1~f104919225.en.html

for banks. Under the Basel III Standardised Approach, banks are allowed to use credit risk ratings from recognised external credit rating agencies, where available, to determine the credit risk weights of their assets. Another important use of credit rating is for the calculation of liquidity requirements, where high-quality liquid assets (HQLA) must fulfil minimum requirements. As such, banks incorporate ESG risks both through relying on CRAs to incorporate ESG into their rating process and increasingly through using ESG rating agencies to assess their risks.[6] Therefore, how ESG risks are integrated into credit rating for banks' capital requirements will have direct implications on prudential supervision. Consequently, the problematic nature of the ESG rating market and the integration of ESG into CRAs' ratings also complicates the supervisory work of the ECB.

In short, **given that the ESG credit rating market has been growing without proper checks and regulation, it would be inadvisable for the ECB to rely excessively on ESG data** and methodology. We are currently witnessing two contradictory movements: on the one hand, the ECB is increasingly relying on ESG data for their monetary and supervisory operations; on the other hand, the market for ESG data is plagued by several issues, as we argued in the previous sections. Therefore, **to avoid falling into a trap of its own making, the ECB, instead of being a data-taker reliant on external actors, should become a data-maker and use its in-house credit assessment systems to evaluate the ESG risks pertaining to assets accepted as collateral** (see Abdelli and Batsaikhan, 2022).

6. As integration of ESG risk is required under Pillar 2 as per ECB guidelines on climate-related and environmental risks, https://www.bankingsupervision.europa.eu/ecb/pub/pdf/ssm.202011finalguideonclimate-relatedandenvironmentalrisks~58213f6564.en.pdf.

4. LEGISLATIVE FRAMEWORK (OR THE LACK OF IT)

4.1. Current framework

This section briefly reviews the current (virtually non-existent) regulatory framework of ESG rating agencies, and ESG rating, at the EU and state level.

At the EU level, ESG rating agencies are only lightly regulated (EC 2020, 21-22). As we have seen, most credit rating agencies are head-quartered in the US. Those which have subsidiaries in the EU (e.g. Moody's, Fitch, S&P) are subject to the CRA regulation, which applies to all businesses providing CRAs on the internal market (see below). For the smaller external CRAs, which do not have a subsidiary in the EU, the ESMA (the regulating body responsible for the supervision of CRAs in the EU) can decide, within the current legislative framework, to treat them on an equivalence basis. In short, this means that non-EU CRAs can obtain an official certification to operate in the EU if they meet some minimal requirements and if they are not "systemically important" to the financial stability of one member state.[7]

Beyond this certification process, some minimal transparency obligations for ESG firms and ESG products exist.[8] In particular, they will have obligations regarding the naming of ESG products and ESG funds (ESMA 2022), which should not be misleading and which cannot use the word 'sustainable' unless a minimal proportion of investments can be defined as sustainable according to the SFDR legislation.[9] However, beyond these requirements, the European Commission itself notes that "no specific regulations apply to the provision of

7. See https://www.esma.europa.eu/supervision/non-eu-credit-rating-agencies

8. See EU Regulation 2019/2088 and Commission Delegated Regulation 2022/1214, as well as Art 114 of the TFEU (formerly Art 95.)

9. See EU Regulation 2019/2088 (SFDR), especially art.2(17): "Sustainable investment means an investment in an economic activity that contributes to an environmental objective, as measured, for example, by key resource efficiency indicators on the use of energy, renewable energy, raw materials, water and land, on the production of waste, and greenhouse gas emissions, or on its impact on biodiversity and the circular economy; or an investment in an economic activity that contributes to a social objective, in particular an investment that contributes to tackling inequality or that fosters social cohesion, social integration and labour relation;, or an investment in human capital or economically or socially disadvantaged communities, provided that such investments do not significantly harm any of those objectives and that the investee companies follow good governance practices, in particular with respect to sound management structures, employee relations, remuneration of staff and tax compliance." See also Annex II and Annex III of Commission Delegated Regulation 2022/1288 for more operationalizable definitions.

sustainability-related data, ratings and research (beyond laws that govern any organisation or individual that publishes information)" (EC 2020, 22).

Regulation is also weak at member state level. Some EU countries impose disclosure obligations on companies and investors, but not on ESG rating agencies. And there is little coordination or consistency among countries (EC 2020, 23). Furthermore, there is little hope of self-regulation. The sector launched several initiatives (ARISTA, DDDS, GISR) but most have faded from view or have not attracted much interest. At the international level, IOSCO (International Organization for Securities Commissions) has made recommendations, which do little to strengthen the sector and tackle fundamental problems (IOSCO 2021). Once again, lack of common definitions and accepted criteria have hindered the process of establishing common rules and methodologies across rating providers (EC 2020, 29).

Lack of regulation has led the EU into a trap: while ESG ratings have become extremely important within the drive to foster the green transition in the EU, there is no accepted legal definition of what ESG actually means, and no clear and binding legal framework for ESG rating agencies. For now, the determination of the sustainability risks of an asset is simply left to market participants. Furthermore, there is also a risk of "shopping" for the most lenient sustainability standard: lack of regulation means that actors can basically tailor their investment strategies according to their own conception of sustainability. Finally, the lack of regulation is also hampering the credibility of ESG rating agencies themselves, which many investors do not consider as serious providers of investment research (EC 2020, 23; EC 2022).

4.2. Calls for increased regulation of ESG

As a consequence of these problems, virtually everyone concerned with ESG is demanding increased regulation. In a recent consultation conducted by the EC (EC 2022), almost all respondents replied that they value transparency in data sourcing and methodologies as well as the accuracy and reliability of ESG ratings. However, a large majority of respondents (over 83%) also noted that the market for ESG ratings is not functioning well today, and that the lack of transparency on the methodologies used by the credit rating agencies is a problem. In particular, a large majority recognizes that there are significant biases in the methodology used by providers, and that the market is prone to potential conflicts of interest.

In this context, almost all respondents (94%) are demanding increased regulation, whether by a public authority or by the industry itself (self-regulation). Unsurprisingly, the main element that needs to be addressed concerns transparency (90+%), followed by avoiding potential conflicts of interests (80%), improving the reliability and comparability of ratings (73%), clarifying objectives of different types of ratings (70%), and clarifying what ratings mean and what they cover (68%).

Some proposals for regulation have already emerged. The EC has called for increased transparency with respect to the underlying methodologies used by ESG rating agencies as well as for higher standards of disclosure by companies and asset managers (EC 2020, 177–179). It is currently preparing a regulatory proposal, which is due to be presented in June 2023.[10] As we have seen, the ECB has also published its own proposals for increased transparency (Breitenstein et al. 2022). Yet, as we argue in the next section, this is far from sufficient.

10. See the tentative agenda of the EU Commission meetings.

5. POLICY RECOMMENDATIONS

We believe that regulation is necessary. Most importantly, regulation should decrease the likelihood of conflicts of interest, clarify whether ESG ratings are about ESG risks for the companies and financiers or ESG impacts generated by companies and financiers, improve definitions, increase the transparency of methodologies and of data collection, and transform ESG ratings into real tools at that help build a more sustainable financial system. Accordingly, we call legislators and supervisors to:

1. Develop a set of **requirements for ESG rating agencies to reduce the likelihood of conflicts of interest** and remediate their effects.

2. Develop **minimum standards for the labelling and certification of ESG ratings** with the aim of clarifying the scope of analysis of each of its elements (E, S and G). Moreover, each ESG rating should clearly indicate whether it covers ESG risks for companies, ESG impacts of companies, or both.

3. **Align the environmental element of ESG with the 1.5°C target set by the Paris Agreement, the reduction of GHG emissions, and the phase-out of high impact activities.** The Paris-Aligned Benchmarks (PABs), recently introduced in the EU, could constitute a model and a first step forward.[11] The social factors should at least be aligned with the core ILO labour standards and UN Guiding Principles on Business and Human Rights.

4. Demand **higher transparency standards from ESG credit rating providers regarding their methodology. More specifically, full transparency on methodology should be required and mandatory for their clients as well as for**

11. PABs require a 50% reduction in greenhouse gas (GHG) emissions compared to a fund's parent index in year one and a 7% year-on-year reduction of GHG emissions relative to the fund itself. In addition, there are several exclusions, such as adhering to the EU Taxonomy's "Do No Significant Harm" (DNSH) requirements. See the Regulation on the EU Climate Transition Benchmarks (2019) and the corresponding Delegated Regulation (2020).

regulators.[12] Supervisory authorities should be able to check the alignment of these methodologies with regulatory requirements. Methodologies should track sustainability risks and impacts, in an adequate way, while avoiding greenwashing and conceptual vagueness.

5 **Require all ESG providers to be registered and supervised by an EU agency, ESMA, which should be empowered to access all relevant information needed to assess the compliance of ESG providers and ESG data with EU legislation.** Regulators should make sure that auditing and verification of an ESG rating is done properly. In turn, this should prevent further greenwashing based on incomplete and unverified data and conclusions.

6 Review existing legislative requirements so that **ESG regulation applies equivalently and horizontally to the ESG business of CRAs and to ESG data and rating providers.**

7 **Adapt reporting requirements and other administrative tasks to the size and market relevance of ESG raters**, in order to decrease market concentration, allow smaller players to enter the market, and thus create a competitive and innovative market for ESG rating data and methodologies.

12. Especially in the case of transparency for clients, an adequate protection of intellectual property rights over methodologies should be guaranteed to protect the business model of rating agencies.

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