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PensionsEurope Position Paper on the European Commission's proposal for ESG rating activities

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PensionsEurope welcomes the European Commission's proposal on ESG ratings. This legislation provides many solutions to current market shortcomings, such as enhancing transparency on methodologies and operations, regulating conflict of interests, establishing rules for third-country providers, and providing specific measures for smaller ESG providers. However, we believe that some areas in the proposal for ESG rating activities require further clarifications and amendments, which we would like to discuss below.

1. The scope of the proposal

a) Inclusion of ESG data in the scope of the regulation

The efficient regulation of the ESG rating market relies on the creation of a holistic regulatory framework for data and rating providers. This framework must cover both financial and non-financial information. Indeed, while ESG raw data and ESG data products were initially included in the 2022 European Commission's consultation on the ESG ratings market, they are now outside of this proposal's scope. Extending the regulation to ESG data, however, would align with the recommendations outlined in the IOSCO 2021 report on ESG ratings to which this regulation makes reference.

ESG data are as important as ESG ratings in investment decisions and regulatory disclosures. The quality of ESG ratings can only be guaranteed by the quality of ESG data. Many ESG ratings users also buy ESG data services due to large number of investee underlying assets and data points. There is also a lack of a fully accessible data base.

Moreover, ESG data play a vital role in implementing sustainable investment strategies and managing sustainability risks. The Corporate Sustainable Reporting Directive (CSRD) and the European Sustainability Reporting Standard (ESRS) should improve the accuracy of ESG data. Nevertheless, some gaps will persist for non-EU companies and EU companies. This is explained by the information disclosure being subject to each entity's materiality assessment, but also the lack of international reporting and audit standards for ESG data. Consequently, ESG data providers use diverse methods to obtain company-related ESG data. The absence of proper regulation and standardised methodologies can leave data users uncertain about the reliability and comparability of these approaches. It also increases the risk of greenwashing.

For these reasons, the regulation's scope must cover ESG data alongside ESG ratings to ensure transparency and reliability throughout the EU sustainable finance market.

b) ESG ratings produced for internal purposes in Article 2 (2) b

We support that ESG ratings regulated by financial undertakings produced for internal purposes remain outside the scope of this proposal. However, in many Member States, IORPs do not produce ESG ratings as such, but risk assessments, on which they rely for their ESG considerations. Small financial undertakings with limited resources, such as IORPs, must be able to continue relying on their in-house assessments. This should be specified in the proposal, for instance in a Recital. Indeed, IORPs should not be forced to buy ESG ratings from providers included in the ESMA's official register (Article 13). Requiring IORPs to buy external ESG ratings would disproportionally drive up their costs. It would lead to lower pensions being paid out to present and future beneficiaries. Such risk is especially important, as the market for ESG ratings will probably shrink due to this proposal, thereby causing prices to rise.

c) Clarification required on the definitions in Article 3

We believe that the definitions in Article 3 require further clarification. Firstly, the definition of ESG rating states that *''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''*. We would request more guidance on the meaning of 'opinion', 'score', and ´ranking system´. Therefore, we propose amending the definition of 'ESG rating' derived from the IOSCO's recommendations in the following way:

''ESG ratings' refer to the broad spectrum of rating products that are marketed as providing an opinion regarding an entity, a financial instrument or a product, a company's ESG profile or characteristics or exposure to ESG, climatic or environmental risks or impact on society and the environment that are issued using a defined ranking system of rating categories, whether or not these are explicitly labelled as 'ESG ratings'.'

Secondly, the definition of ESG data products needs to be included in Article 3 to align with our previous request concerning the extension of the scope (please refer to 1 a). We propose the below definition:

''*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'.'*

2. Transparency requirements and methodologies

a) Recipients of disclosed information

We strongly support the initiative to enhance transparency in the ratings' methodologies and the use of data sources. The comprehensive disclosure requirements will strengthen the reliability, comparability, and trust in ESG ratings, and boost market competition.

Additional clarification on the recipients of the disclosed information as detailed in Annex III 2 is still required. Information is not only important for rated entities or subscribers but also to rating users, including institutional investors or financial institutions. As such, the disclosure obligations should apply fully. This should be done regardless of the user receiving the rating from the rating agency or a third party. Still, it is crucial that further access to information on the rating's underlying does not lead to more regulatory burden for pension funds.

b) Transparency on costs

We also appreciate the European Commission's efforts to address the issue of fairness in pricing practices and encourage providers to ensure that fees are '*fair, reasonable, transparent, non-discriminatory and are based on costs*', as indicated in Article 25.

We are still concerned about the disclosure of the fee structure not being compulsory. Mandatory reporting of data fees is vital for achieving a balanced approach to financial product pricing. It can ultimately benefit end investors, especially retail investors. However, the absence of compulsory transparency may discourage rating providers from making concerted efforts to price financial products fairly. Consequently, we propose to amend Article 21(1) to include transparency requirements on fees from providers.

c) Compliance with other EU legislations as part of the EU sustainable framework

Further clarifications are required on the disclosure requirements in methodologies (Annex III). It should be specified how these requirements are connected to the sustainability definitions of the Sustainable Finance Disclosure Regulation (SFDR) and the Taxonomy, to which point 2 (B) of the proposal's annexes refers.

We also seek guidance on the link between the methodologies and broader requirements included in this regulation with other pieces of legislation in the EU sustainable framework. These parallel regulations all involve the disclosure of ESG requirements. It is important to avoid any additional reporting burden for pension funds derived from an overlap between regulations.

d) Request for information

As per Article 30, ESMA can collect the information required for the supervision of both ESG rating providers and third parties. There is a concern related to the potential risk of circumvention or business misconduct, given that Article 30 does not mandate the provision of requested information.

It is crucial that the ESG rating agency is responsible for providing the requested information in all circumstances. The responsibility should extend to group companies as well. This approach will promote transparency and avoid any impediment in the information-sharing process.

e) Future achievement – Comparative framework for ESG ratings based on credit ratings

In the regulatory framework for banks (CRD/CRR) and insurers (Solvency II), the ESAs are required to create mapping tables of credit assessment from External Credit Assessment Institutions (see EBAs and ESMAs overview; some recent amendments of the mapping tables under CRR (JC 2021 38); and Solvency II (JC 2021 39)). Although ESG ratings are different and more complex than credit ratings, we propose developing similar mechanisms for ratings from ESG rating agencies. For credit ratings, this is done through the 'allocation of credit assessments of external credit assessment institutions to an objective scale of credit quality steps'.

3. The nature of the ESG rating market

In our response to the 2022 EC consultation, we expressed our concerns about the ESG rating and data markets' oligopolistic nature. Over time, this market has experienced significant growth, resulting in a concentration of non-EU providers, alongside numerous small-sized providers. This situation has given rise to several issues. For instance, non-EU large providers operate under different rules. It undermines the effectiveness of the European regulatory framework. Additionally, the dominance of major players has negatively impacted smaller entities. It has led to higher prices, barriers to entry, reduced market competition, and limited innovation.

We fully support the European Commission's move to impose equivalence rules on third-country providers, introduce mechanisms of endorsement and recognition to uphold the EU's legislative framework, and implement specific measures for smaller players. However, addressing the oligopolistic nature of the market requires further intervention, including transparency measures concerning pricing (see point 2 b), as well as considerations on licensing and contractual matters. Specific actions should follow to encourage the development of smaller players in the market.

About PensionsEurope

PensionsEurope represents national associations of pension funds and similar institutions for workplace and other funded pensions. Some members operate purely individual pension schemes.
PensionsEurope has **25 member associations** in 18 EU Member States and 4 other European countries[1].

PensionsEurope member organisations cover different types of workplace pensions for over **110 million people.** Through its Member Associations PensionsEurope represents **€ 7 trillion of assets** managed for future pension payments. In addition, many members of PensionsEurope also cover personal pensions, which are connected with an employment relation.

PensionsEurope also has **20 Corporate and Supporter Members** which are various service providers and stakeholders that work with IORPs.

PensionsEurope has established a **Central & Eastern European Countries Forum (CEEC Forum)** to discuss issues common to pension systems in that region.

PensionsEurope has established a **Multinational Advisory Group (MAG)** which delivers advice on pension issues to PensionsEurope. It provides a collective voice and information sharing for the expertise and opinions of multinationals.

What PensionsEurope stands for

- A regulatory environment encouraging workplace pension membership;
- Ensure that more and more Europeans can benefit from an adequate income in retirement;
- Policies which will enable sufficient contributions and good returns.

Our members offer

- Economies of scale in governance, administration and asset management;
- Risk pooling and often intergenerational risk-sharing;
- Often "not-for-profit" and some/all of the costs are borne by the employer;
- Members of workplace pension schemes often benefit from a contribution paid by the employer;
- Wide-scale coverage due to mandatory participation, sector-wide participation based on collective agreements and soft-compulsion elements such as auto-enrolment;
- Good governance and alignment of interest due to participation of the main stakeholders.

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[1] EU Member States: Austria, Belgium, Bulgaria, Croatia, Denmark, Finland, France, Germany, Greece, Hungary, Ireland, Italy, Luxembourg, Netherlands, Portugal, Romania, Spain, Sweden. Non-EU Member States: Iceland, Norway, Switzerland, UK.