Targeted consultation on the functioning of the ESG ratings market in the European Union and on the consideration of ESG factors in credit ratings

RICS response

Introduction

The European Commission (EC) has launched a targeted consultation on the functioning of the ESG rating market in the European Union and on the consideration of ESG factors in credit ratings. The consultation was open until 6 June.

The targeted consultation on environmental, social, and governance (ESG) ratings and sustainability factors in credit ratings is an integral part of the renewed sustainable finance strategy adopted in July 2021 by the EC. Both credit ratings and ESG ratings are opinions provided by specialised entities and used by financial institutions and professional investors.

We have participated in this consultation with the objective to help the EC gain insight into the functioning of the market for ESG ratings.

Relevance of ESG

With growing interest in ESG criteria, investors need a way to assess the ESG performance of a company objectively. ESG ratings are designed to help investors identify and understand financially material ESG risks to a business. Companies are evaluated based on publicly available information such as media sources and annual reports, with scores given for each material 'E', 'S' and 'G' topic, alongside an overall score.

These unique scores are used by investors as a proxy of ESG performance. Companies that score well on ESG metrics are believed to better anticipate future risks and opportunities, be more disposed to longer-term strategic thinking, and focused on long-term value creation.

The consultation

This consultation will help the Commission gain a better insight into the functioning of the market for ESG ratings, as well as better understand how credit rating agencies (CRAs) incorporate ESG risks in their creditworthiness assessment. Responses from market participants will feed into an impact assessment that will evaluate whether a possible policy initiative on ESG ratings and on sustainability factors in credit ratings is needed. These actions are expected to contribute to the achievement of the European green deal objectives by improving the quality of information on which basis investors, businesses and other stakeholders take decisions impacting the transition to a sustainable economy.

The consultation is split into two segments with Part A focusing on the functioning of the ESG rating market in the European Union. The second segment of the consultation termed 'Part B' focuses on the Incorporation of ESG factors in credit ratings.

Our response

In our response, we have focused on the use of ESG ratings and dynamics of the market, the functioning of the ESG rating market and the need for EU Intervention.

Use of ESG ratings and dynamics of the market

ESG refers to the three principal factors that are used to assess the sustainability, social and ethical impacts of a firm. The real estate sector can have a profound impact on the environment, communities, and people. Some examples of this include the rehabilitation of public space, affordable housing, investment in green buildings, social housing as well as green infrastructure and implementation of biodiversity net gain in real estate developments. As a global professional body responsible for setting standards in the real estate sector, RICS is interested in taking note of how the sector is performing against specific sustainability and ESG indicators. We believe that ESG ratings are an important tool for measuring and benchmarking ESG and sustainability performance of real estate and property firms over the medium to long term.

Sustainability has become vital for real estate investors. ESG ratings will continue to influence investment and divestment decisions and therefore will increasingly shape real estate valuation. RICS has intensive experience in developing valuations standards and has already developed guidance on how professionals can incorporate sustainability and ESG in asset valuation[1] and is interested in developing additional guidance and standards in this area.

RICS has worked extensively to develop standards and guidance to advance sustainability and ESG considerations across the sector. For one, the development of the International Building Operation Standard (IBOS) introduces a new approach to measure and manage how buildings perform by equipping professionals with key data to inform decisions around ESG, sustainability and user experience. Furthermore, the RICS Responsible Business Framework has been designed to help members and firms adopt sustainable solutions that can deliver economic, social and environmental benefits.

Sufficient offer of ESG ratings from providers located in the European Union

While there are sufficient ESG rating providers, the quality of ESG ratings can be drastically improved. There is a lack of transparency around methodologies that are being used behind ESG ratings making it difficult for investors and stakeholders to understand how specific data disclosed by firms to rating providers are handled and how these ratings are calculated.

We believe that there is an urgent need for reliable and consistent information relating to sustainability and ESG, particularly for the real estate sector which is not only responsible for nearly 40% of global carbon emissions but also has a significant social impact as described in earlier comments. This is important to meet the data needs of investors. Indeed, reliable data and information around ESG will help investors direct finance towards real estate projects that can have positive environmental and social impacts. These projects could also help support the UN Sustainable Development Goals as well as national net-zero targets.

One crucial issue that we want to highlight is that in the case of the real estate sector there is a need to improve data collection, management, and analysis. For ESG rating providers who have access to some of this information, it would be useful to know what is being measured and whether ESG and sustainability factors are being assessed in a practical and meaningful way.

EU intervention

Legislative intervention at the EU Level could help the following areas:

- Improving transparency on the operations of the providers,

[1]https://www.rics.org/globalassets/rics-website/media/upholding-professional-standards/regulation/valuation/sustainability-and-esg-guidance-note_december-2021_v1.pdf

- Improving transparency on the methodology used by the providers,
- Improving the reliability and comparability of ratings,
- Avoiding potential conflicts of interests

Regulatory intervention can include developing a set of disclosure standards for the ESG rating market. These standards could be a focus on ESG rating agencies having to disclose what data they are considering, and what metrics they are using to generate ESG scores and/or ratings.

Furthermore, legislative intervention is also necessary to avoid potential conflict of interest, particularly in the case of rating agencies providing ESG scores alongside other ESG-related products and services such as paid advisory services. We agree with the results of the study that there needs to be a separation between departments. Divisions that are working on ESG scores need to be kept separate from departments that offer ESG advisory services to avoid potential conflicts of interest. If this is not the case, then as mentioned above this calls into question the legitimacy of ESG scores.

Non-regulatory intervention (e.g., guidelines, code of conduct) could help in the following areas:

- Clarifying objectives of different types of ESG ratings,
- Clarifying what is meant by and captured by ESG ratings, to differentiate from other tools and services,
- Providing some supervision on the operations of these providers

Non-regulatory intervention could help create clarity around the ESG rating market. We believe it is important to develop definitions of what is meant and captured by ESG ratings and what the purpose of an ESG rating is. These definitions need to be globally aligned. Guidelines could help create an international benchmark and standards that ESG rating and their providers should meet.

Next steps

- This consultation and the call for evidence will directly feed into an impact assessment that the EC will prepare towards the end of the year – this will determine the direction the EC takes in terms of possible intervention.
- Depending on the learnings of the impact assessment, a possible legislative or non-legislative initiative is expected by Q1 2023.

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