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VCI POSITION PAPER ON THE PLANNED EU REGULATION OF ESG RATINGS

How should ESG ratings be designed to reflect the sustainability performance of companies?

Introduction

ESG ratings have become established on the capital market, which make it their business to evaluate the sustainability performance of companies. The ratings often form the basis for investment decisions by sustainability-oriented investors to select suitable securities. In addition, the ESG ratings are used as a basis for compiling company values for sustainability indices. In this context, ratings are of vital importance in assessing performance against the backdrop of the increasing importance of the sustainable capital market. A look at the figures of the sustainable capital market illustrates the increasing relevance: According to the Global Sustainable Investment Alliance (GSIA), the market volume of sustainable capital investments amounted to 35.3 trillion US dollars in 2020, which means a growth of almost 55 percent based on 2016. In addition, ESG ratings can help to increase the sustainability performance of companies by showing in which areas there is room for improvement and where a company should be ranked in comparison to its competitors.

In principle, the German Chemical Industry Association (VCI) supports the EU Commission's plan to make ESG ratings more transparent with the help of minimum requirements and to make them easier to use for important stakeholders. In this context, we welcome the broad scope of the proposed regulation with its minimum requirements. From our point of view, it makes sense to comprehensively improve the reliability of the rating market around ESG, also because it leads to a relief for companies if the broadest possible selection of rating agencies is subject to the requirements.

We would like to support the development of high-quality standards by contributing the practical knowledge of the chemical and pharmaceutical industry. To this end, we have outlined below what we consider to be the key aspects for future regulation.

Uniform definition of ESG ratings

Currently, there are many different ESG rating providers, which often assess different aspects (e.g. risk vs. impact, best-in-class vs. best-in-progress). This puts different dimensions of sustainability in the centre of attention. Depending on the focus, this can lead to different assessments and statements of ratings. Different focal points can be important for investors in order to be able to invest in a targeted manner depending on the objective (e.g. status quo vs. development).

For comparability between different ESG ratings to be possible, **different methodologies and purposes of application should be sufficiently considered in the regulation**. Here it seems sensible to first define the purposes of application that are to be regulated. Based on this, it can subsequently be determined which methodology is to be pursued for which application purpose to ensure comparability of ratings. In this way, it can be ensured that the information needs of investors are met, depending on the objective. Furthermore, rating providers should be requested to clearly communicate the objectives of their ratings (e.g. risk rating vs. assessment of sustainability performance).

Only the uniform definition of ESG ratings for different application purposes enables transparent and comparable performance assessments.

Dealing with controversies (e.g. red flags)

Controversies have more and more weight in the methodologies of ESG ratings and the quality of the inclusion of controversies in ratings varies greatly between rating providers. A single controversy can have an immense impact on how investors evaluate companies. In addition, ESG rating providers may produce separate controversy reports. For independence and transparency in dealing with controversies, it is important to consider the issue in the regulatory proposal. A framework with transparent requirements should be created that allows for a classification. To ensure the effectiveness and independence of the complaint mechanism in Art. 18, we also propose an independent arbitration mechanism for cases that cannot be resolved directly between the ESG rating provider and the rated entity. Such a binding arbitration mechanism would ensure that complaints can be dealt with before an independent body. In addition, any disputed ESG rating or assessment will be flagged until the proposed independent arbitration has reached a decision.

The regulation of ESG ratings must include the handling of controversies to establish transparency regarding the approach and scope.

Handling data: Determining the basis for evaluation

For ESG ratings to assess the sustainability-related performance of a company, the availability of high-quality and meaningful data is crucial. A different number of data points are used for the rating depending on the rating provider. Furthermore, different data sources are used: While some providers only use the annual report as a source, some agencies also evaluate the website of companies or accept data that is not available to the public (e.g. internal guidelines).

The use of different sources of information is one reason why ESG ratings arrive at different performance assessment results. To ensure that the results of ESG rating providers are comparable and that the same conditions are created for all companies, it is advisable to **define minimum requirements for the data basis**. In this context, the **European Sustainability Reporting Standards (ESRS)**, which are currently being developed, should be used as a benchmark to prevent the creation of further requirements in sustainability-related disclosure. This can also prevent companies from having to comply with unreasonable additional work when responding to rating requests, and the ratings end up with fundamentally different results due to divergent sources of information.

To ensure the comprehensibility and comparability of ESG ratings, it is necessary that the same data basis is used, and that recourse is made to established sustainability standards (ESRS).

The materiality analyses of companies according to the specifications of the ESRS must be taken into account

Companies must prepare a materiality analysis for sustainability reporting. With the help of this analysis, it should be determined which topics are material for a company. Currently, different concepts are used. Within the framework of the ESRS, the EU has made clear specifications as to how a materiality analysis must be designed in the future, insofar as a company falls under the Corporate Sustainability Reporting Directive (CSRD) (double materiality: impact and financial materiality). It can currently be observed that the topics classified as material by rating agencies are often not congruent with the materiality analyses of companies.

The materiality analyses of companies (and not the rating agencies) must be used to determine the relevant areas for ESG ratings.

Use of publicly available information

While some rating providers only consider publicly available data, other providers also include internal company information in the analysis and request this from the companies. In our view, against the backdrop of the significant expansion of reporting obligations on sustainability through the ESRS, it does not make sense for further internal company information to be requested in addition to the publicly available data. The information is sufficient to create a comprehensive picture of a company's sustainability performance, while at the same time keeping competitively relevant information protected.

To ensure that competition-relevant information remains protected, ESG ratings should work exclusively with publicly available data.

Strengthen dialogue between rating providers and companies

Each rating agency offers different possibilities for affected companies to engage in a dialogue during the rating process. While some rating providers only work with public data and do not communicate directly with the companies, other providers maintain a lively exchange with the companies to ensure, within the framework of a feedback process, that all necessary information for the rating has been collected and that the assessment is correct. **For companies to be able to constructively participate in the service provision, it is necessary that the rating process is standardised.**

First, there should be **standardised timings for the announcement and duration of ratings**. If a rating is announced early, companies can make sufficient resources available to process the rating during the relevant period. This should also consider the publication period of the sustainability and annual report to ensure that up-to-date information is available. In addition, it is important that companies are given a say in determining the timing of the rating process. Small and medium-sized enterprises must be able to provide the necessary capacity to respond to rating requests. Also, due to the information needs of investors, ratings should be updated at least annually.

As a basis for dialogue in the rating process, it is necessary that **the methodology and the underlying performance indicators are transparent for companies** (including weighting and assessment criteria). In addition, companies must be able to obtain insight into their own rating for each underlying performance indicator. If there are changes to the rating model or an update of the results, companies should have the opportunity to track these adjustments. This ensures that companies can provide the required information that leads to a meaningful rating and that investors make their investment decisions based on up-to-date information.

During the rating process, **companies should be involved in the assessment process by means of a clearly defined feedback process**. This gives rating agencies the opportunity to address open questions in a given period of time and to show in which areas there is potential for improvement. Companies, in turn, can understand how the assessment is made and, if necessary, contribute further relevant publicly available information.

The inclusion of affected companies in the rating process is indispensable to ensure the completeness and validity of a rating. For this purpose, the rating process should be clearly defined while adhering to appropriate feedback periods.

Establishment of an independent arbitration body

We welcome the fact that the regulatory proposal provides for an independent complaints procedure. To ensure that complaints are handled professionally, independently and promptly, it is important to guarantee the independence and effectiveness of the complaints mechanism. Therefore, we propose the establishment of an independent arbitration mechanism for those cases that cannot be resolved directly between the rating provider and the company. A binding arbitration mechanism would ensure that complaints can be addressed before an independent body. In addition, any disputed ESG rating or assessment should be flagged until the proposed independent arbitration has reached a decision.

To ensure the objectivity and validity of ESG ratings, an independent arbitration body should be established.

Recognition of established industry standards and consideration of different regulatory requirements

When assessing sustainability-related performance, rating agencies are often guided by regulatory requirements as well as standards and certifications. These serve as a basis for assessing whether companies fulfil their obligations in certain areas. In practice, established standards are often used and information on implementation and strategy is required.

In principle, an orientation towards regulatory requirements and established standards and certifications is to be welcomed. However, the different regulatory requirements and cultural differences in certain countries must be taken into account (e.g. with regard to the salary of top management: while it is common in the Anglo-American region for the variable component to be very high, there is a clear tendency towards a higher fixed component in the European region).

In addition, standards should also be recognised that have established themselves as the standard in different sectors. Otherwise, a distorted picture of the performance of companies will emerge and there will be no comparability.

Established sector-specific standards and certifications must be recognised and used in performance ratings. In addition, cultural differences must be sufficiently addressed.

Summary

ESG ratings are of decisive importance on the capital market in steering investments towards sustainability. It can currently be observed that rating providers have established different approaches to assessing performance. **For investors to be able to make informed investment decisions based on ESG ratings, a standardisation of the requirements on the part of the EU is to be welcomed.** The focus should be on a **practicable design and orientation towards established standards**, and a dialogue process between rating agencies and rated companies should be defined. In this way, the transparency, comparability, and validity of ESG ratings can be increased.

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