AmCham EU
SPEAKING FOR AMERICAN BUSINESS IN EUROPE

Consultation response

ESG ratings and sustainability risks in credit ratings

AmCham EU speaks for American companies committed to Europe on trade, investment and competitiveness issues. It aims to ensure a growth-orientated business and investment climate in Europe. AmCham EU facilitates the resolution of transatlantic issues that impact business and plays a role in creating better understanding of EU and US positions on business matters. Aggregate US investment in Europe totalled more than €3.4 trillion in 2021, directly supports more than 4.9 million jobs in Europe, and generates billions of euros annually in income, trade and research and development.

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Introduction

The American Chamber of Commerce to the European Union (AmCham EU) supports the objective of a well-functioning global capital market which integrates Environmental, Social, Governance (ESG) considerations. We are grateful for the opportunity to contribute the views of our members to the European Commission's Call for Evidence on the functioning of ESG ratings market in the EU and on the consideration of ESG factors in credit ratings.

We support the analysis on ESG ratings and ESG in credit ratings undertaken to streamline this market, including through the European Commission's study on sustainability-related ratings[1] and the final recommendations published by the International Organization of Securities Exchanges (IOSCO)[2]. As identified by IOSCO, the influence of ESG ratings and data providers is expected to continue to grow – warranting a well-founded interest in the business models and activities of these actors, which include AmCham members.

To the extent that the European Commission may decide to pursue a policy initiative on ESG ratings, we would note that the IOSCO recommendations must function as the high-level framework in which further actions are developed. In addition, further regulatory action must still ensure that as this market grows, innovative products and methodologies can still be developed – avoiding unintended stifling.

With respect to ESG ratings, we identify two specific areas meriting further consideration (methodological transparency and conflicts of interest), while noting two horizontal considerations that should underpin all further efforts undertaken (the need for mature ESG data and international harmonisation).

However, AmCham EU considers that **no further action is required in order to clarify the legislative framework for credit rating agencies.** Rather, we would therefore urge the Commission to monitor the ongoing progress that credit rating agencies (CRAs) have demonstrated in providing greater transparency on how ESG factors can affect credit ratings.

ESG Ratings

1. Promoting transparency around methodologies

AmCham EU would not encourage a prescriptive approach towards the determination of appropriate methodologies for creating ESG rating products. Rather, we would welcome further transparency to ensure that users and companies being rated can assess:

- The specific drivers that underpin particular ratings, including any weightings used.

[1] https://op.europa.eu/en/publication-detail/-/publication/d7d85036-509c-11eb-b59f-01aa75ed71a1/language-en/format-PDF/source-183474104
[2] https://www.iosco.org/library/pubdocs/pdf/IOSCOPD690.pdf

- The dimensions of a company's performance that the ratings are meant to measure, ie financial risk for the company stemming from its approach to managing ESG factors, impact of corporate activity sustainability factors, a combination of both, etc.
- The sources of the ESG data used in the rating products.

Clarity around these elements would facilitate comparability of companies and ESG ratings, while offering predictability to users, product developers, and companies being rated.

2. Managing conflicts of interest

As noted by the Final IOSCO Report, it is important for ESG rating providers to remain independent, objective and free from conflicts of interests. The disclosure and management of conflicts of interests should be an important consideration for ESG rating providers and for potential policy initiatives in this space.

Thus, AmCham EU supports the need to ensure the independence and objectivity of ESG ratings, as it is a key tenet of investor protection. The European Commission may consider providing further guidance on how to bolster this objectivity by:

- Encouraging the adoption of internal policies and procedures that clearly outline how conflicts of interest are to be identified, managed and mitigated;
- Ensuring appropriate disclosures of these policies and steps undertaken in their remit; and
- Ensuring appropriate separation of businesses, including reporting lines, to facilitate the management of potential conflicts of interest.

3. Importance of the quality of underlying ESG data

As IOSCO has pointed out in its work in this area, ESG rating providers must rely on the quality of ESG disclosure available to them and currently there is no standardised reporting framework. Specifically, IOSCO's fact-finding survey pointed to two main characteristics of the ESG data landscape that are problematic: availability (varying levels of ESG disclosures – especially depending on asset class and geographical region) and inconsistency (format, content and location of disclosures).

The quality of underlying ESG disclosures is being addressed through a number of international and EU initiatives including the International Sustainability Standards Board and the Corporate Sustainability Reporting Directive (CSRD) proposal.

AmCham EU strongly supports the European Commission's intent to facilitate the disclosure of reliable, comparable and standardised ESG data through the adoption of the proposal for a CSRD – currently in interinstitutional negotiations. Accompanied by the ongoing work done by EFRAG to define the technical standards that will complete the CSRD, we consider this initiative to be a key element in the development of a robust and reliable ESG rating products market in the European Union (for the international considerations of this effort, please refer to Section 4). This is because ESG rating products are only as reliable as the maturity and comparability of the data that underpins them. To this end, if the European Commission consider further regulatory action on this matter necessary, we see merit in this taking place following the implementation of the CSRD.

As an important caveat, we would like to underline that while ESG data is crucial for the further development of the ESG rating market, there should be no automatic correlation between the way an ESG product is structured and the disclosure or classification frameworks that the ESG data is meant to accommodate – ie the EU's Green Taxonomy and any of its possible extensions, the Principal Adverse Impact (PAI) indicators under the SFDR, CSRD, etc.

4. International Coordination

In order to scale up the mobilisation of private capital towards sustainable investments, it is crucial to consider how further predictability and comparability concerning ESG ratings products can be accomplished across jurisdictions. To this end, the European Commission should ensure that any further steps taken in this area are coordinated with international stakeholders and based on international recommendations, notably, IOSCO.

There is a risk of market fragmentation which could exacerbate issues relating to ESG disclosure and ESG information if any policy actions in the ESG ratings space are not based on the recommendations of IOSCO. In particular, legislative action in the EU with respect to other products used in financial markets (such as benchmarks) has resulted in significant difficulties as other jurisdictions have not adopted equivalent frameworks.

Furthermore, the forthcoming development of an international reporting baseline for sustainability reporting through the work of the ISSB will be crucial in this regard. Considering the significance of the availability of robust ESG disclosure, AmCham EU strongly supports a coordinated approach around a global baseline.

ESG Factors in Credit Ratings

As the Commission's Call for Input recognises, credit ratings are already regulated in the European Union. The CRA Regulation (CRAR) requires that credit rating agencies to consider all relevant factors when determining the creditworthiness of a company, which may include ESG risks. In addition, the European Securities and Markets Authority (ESMA) has adopted guidelines meant to ensure investors are informed adequately concerning how specific ratings may have been influenced by ESG considerations.

As stated in AmCham EU's response to the European Commission's review of the Sustainable Finance Strategy, credit risk metrics, credit rating and prudential standards should not be interfered with in order to attempt to incentivise investment in certain assets. CRAs are required by EU (and non-EU) regulation to have rigorous, systematic, continuous and validated methodologies. They typically take into account all material risks to creditworthiness, including ESG. It is important to maintain their independence while ensuring that their methodologies are transparent.[3] The current EU legislative framework already requires that ESG considerations, to the extent that they reflect of the

[3] http://www.amchameu.eu/system/files/position_papers/contributionf679f5f7-b877-4d07-993a-f321f463d84e.pdf

creditworthiness of a company, be incorporated into credit ratings. As such, no further action is required in order to clarify the legislative framework for credit rating agencies.

Of parallel relevance to this discussion is the ongoing work undertaken by the European Banking Authority (EBA), which seeks to determine the extent to which the risk-based prudential framework for banks incorporates the consideration of environmental risks. The interim conclusion of the EBA, ahead of its final report on the issue expected in 2023, concludes that the Pillar I prudential framework already allows for environmental risks to be considered adequately – including through the use of external credit ratings.

AmCham EU believes that it is important for the Commission to distinguish between ESG factors in credit ratings and ESG ratings. While ESG factors can affect the creditworthiness of an entity, ESG factors are not always relevant or are mitigated by other overriding factors. In this respect, it is important to note the findings of the Network for Greening the Financial System (NGFS) that there is 'no clear direct evidence of a correlation between the final credit rating and the ESG credit factors affecting an entity, due to the presence of other non-ESG-related credit factors (eg cash, liquidity, capital structure, competitive positioning)'.

The NGFS also concluded that 'ESG factors are considered as part of the credit rating process' by CRAs.[4] However, the NGFS notes that challenges exist with regard to the 'visibility of ESG risks makes for further difficulties, as they have to be financially material to a company's performance and operations in order to affect its credit rating'. This stems from the same issues identified above in this paper with regard to the availability of high quality ESG disclosure from companies.

As noted by the NGFS, the ISSB will issue a global baseline of sustainability disclosure standards starting with climate, to complement the IFRS Accounting Standards. The ISSB standards will facilitate comprehensive disclosures with connectivity between climate-related and financial reporting. We support the NGFS' conclusion that 'this will ensure that ESG factors that are material to credit risks can be more accurately assessed by CRAs and financial markets, thereby revealing potential risk differentials'.

We would therefore urge the Commission to monitor the ongoing progress that CRAs have demonstrated in providing greater transparency on how ESG factors can affect credit ratings. We would also encourage the Commission to support the establishment of the international baseline under construction by the ISSB as it implements the EU reporting standards through the CSRD.

[4] https://www.ngfs.net/sites/default/files/medias/documents/capturing_risk_differentials_from_climate-related_risks.pdf