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WORKING DOCUMENT

From: Commission services
To: Working Party on Financial Services and the Banking Union (Sustainable Finance)
Financial Services Attachés

Subject: ESG Ratings - CWP 19 January 2024 - Commission Services non-paper on inhouse ratings

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Non-paper

ESG Ratings' Regulation

ESG ratings developed by regulated financial undertakings

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The Commission proposal foresees that the Regulation should not apply towards ESG ratings produced by regulated financial undertakings in the Union that are used for internal purposes or for providing in-house financial services and products. In other words, where regulated financial undertakings develop their own ESG ratings following proprietary methodologies and use them for own decisions and investments but they don't distribute or publish them in any way, they should not be covered by the Regulation. However, where financial products are accompanied by an ESG rating supporting and justifying their ESG characteristics, and are therefore distributed and published to retail investors, it is crucial for investor protection and market integrity to ensure an equivalent level of transparency on the rating's methodology, data sources and objectives. The Commission proposal does not foresee the need for regulated financial undertakings to be subject to additional organisational requirements than those to which they are already subject in sectorial legislation covering among other things the prevention and management of conflicts of interests.

Positions from the Council and European Parliament

The Council proposes to exclude ESG ratings that are used for internal purposes or are provided to other entities of the same "consolidated group" as well as "incorporated to products or services which are provided by credit institutions, investment firms, fund managers, insurers, benchmark administrators or financial institutions, or required by or derived from a regulatory obligation applicable to such services or products, where such products or services are already regulated under Union law".

The Commission services consider that a wide exclusion for ESG ratings developed by regulated financial undertakings would contradict the objectives of the Regulation to ensure a high-level of transparency and create a level playing field between ESG ratings that are published and distributed by specialised ESG

rating providers (e.g. MSCI, Sustainalytics) and ESG ratings published and distributed by regulated financial undertakings.

The Parliament proposes to exclude ESG ratings produced by regulated financial undertakings that are “used exclusively for internal purposes or for providing in-house financial services and products, including services provided to other entities that are part of the same group as long as the ratings are not disclosed to third parties beyond the group”.

The Commission services consider that the text from the Parliament addresses the issue of transparency (or lack thereof). At the same time, the text could be interpreted as if any ESG rating developed by regulated financial undertakings that are disclosed outside the group would need to follow all obligations from the Regulation, including organisational requirements. This could potentially raise questions with respect to alignment with the organisational requirements but also certain transparency requirements as specified in sectoral legislation.

Position of the Commission services

The Commission services are of the opinion that if regulated financial undertakings distribute or publish ESG ratings developed by them, they should be subject to equal transparency requirements as ESG ratings distributed or published by specialised ESG rating providers. As one of the objectives of the proposal is retail investor protection, retail investors should receive sufficient information about ESG ratings produced by regulated financial undertakings and the origin of the ESG rating should be visibly marked. At the same time, the Commission would like to avoid any duplication of transparency requirements and in the cases when regulated financial undertakings provide equivalent information about objectives, materiality assessment and methodologies of ESG ratings in SFDR factsheet or on websites they should not be required to duplicate them. The Commission services consider that the disclosures stemming from sectoral legislation, e.g. SFDR, do not cover the whole spectrum of disclosure requirements from Annex III of the ESG ratings proposal. The level of disclosures in relation to ESG ratings/scores that have been integrated into investment decisions varies between asset managers. Some disclose only high level overview of methodologies, some provide more explanation as how ESG ratings are integrated in the process of financial product composition as well as provide more detailed overview of ESG ratings objectives and methodologies. However, it is not always clear what is the materiality perspective of ESG ratings used for the investment decision (is it risk or impact or both), what are sources of data, what is the weighting used or whether the methodology is based on scientific evidence” (see also Annex I). It is important to make it explicit that regulated financial undertakings that distribute and publish ESG ratings should disclose the same information as specialised ESG rating providers.

As a result, the Commission would propose the following wording (in red) , using as a basis a text of the Council general approach, to address uncertainties and risks of unlevel playing field :

2. This Regulation does not apply to any of the following:

[...]

(b) ESG ratings produced by regulated financial undertakings in the Union that are:

(i) used for internal purposes, or provided to other entities that are part of the same consolidated group or; for providing in-house financial services and products

(ii) incorporated into products or services which are provided by credit institutions, investment firms, fund managers, insurers, benchmark administrators or financial institutions, ~~or required by or~~ and which are subject ~~derived from a regulatory obligation applicable to such services or products, where such products or services are~~ to disclosure requirements ~~already regulated~~ under Union law, including under, but not limited to, Regulation (EU) 2019/2088, Directive 2013/36/EU, Directive 2014/65/EU, Directive 2009/65/EC, Directive 2011/61/EC, Regulation (EU) 2014/596/~~EU~~ and Regulation (EU) 2016/1011/~~EU~~;

By way of derogation from the preceding provision, regulated financial undertakings that do not disclose ESG rating methodologies under the frameworks as referred to in subparagraph (ii) shall disclose ESG ratings methodology as well as other information as per the requirements laid down in point 1 of Annex III in a fair and transparent manner in the relevant product documentation or on the relevant website, under supervision of competent authorities.

Annex I

I. Overview of how ESG internal ratings/scores are integrated into the investment process.

CASE 1: ESG scores and other internal ESG ratings are used to enhance investment analysis and decision-making. ESG internal ratings can be used at different stages of the investment process depending the type of ESG integration:

- 1) **Screening:** it is used to remove the most sensitive sectors or issuers in order to address the worst ESG risks.
- 2) **Investment research:** ESG scores and ratings are made available to investment teams to support investment decision-making, e.g. some funds avoid investing in a public entity that doesn't have an ESG score.
- 3) **Security selection** for inclusion in portfolios.
- 4) **Portfolio construction**, e.g. some funds aim to hold a higher weighted average ESG internal rating and a lower carbon footprint than the relevant investment benchmark or universe.

CASE 2

ESG rating can be used a “sustainable indicator” i.e. it relates to the rating of the fund and the rating of its benchmark when the fund has a “beat the benchmark” objective.

CASE 3

Following the company selection on the basis of SDG scores, investment teams conduct top-down macro and bottom-up fundamental analysis:

Screen and capture SDG impact

Once companies have been distinguished by their SDG scores, investment teams conduct rigorous top-down macro and bottom-up fundamental analysis. Company valuations also include ESG integration to avoid financial risks from sustainability factors.

Our research supports the view that avoiding companies with negative SDG scores does not reduce alpha opportunities² nor compromise performance capacity³. Moreover, excluding companies with negative SDG scores from the investable universe is not expected to affect factor premiums for quantitative models⁴.

helping corporate leaders understand the benefits of sustainability will lead to improved behavior, more resilient strategy and ultimately better risk-adjusted returns over the long run. Current engagement themes include mining, biodiversity, labor rights, compensation, and governance in emerging markets.

Building on our engagement expertise, we have designed a product with a unique twist. In addition to products designed to identify and invest in high SDG performers (+2 and +3), we have also created an investment product designed specifically to identify, invest and engage with companies with mediocre scores but with potential to improve (-1 to +1). By actively engaging with lower performers, we hope to move the average, elevating SDG scores and ultimately SDG contributions across the entire economy.

as among the first to provide clients
focused equity and credit products'

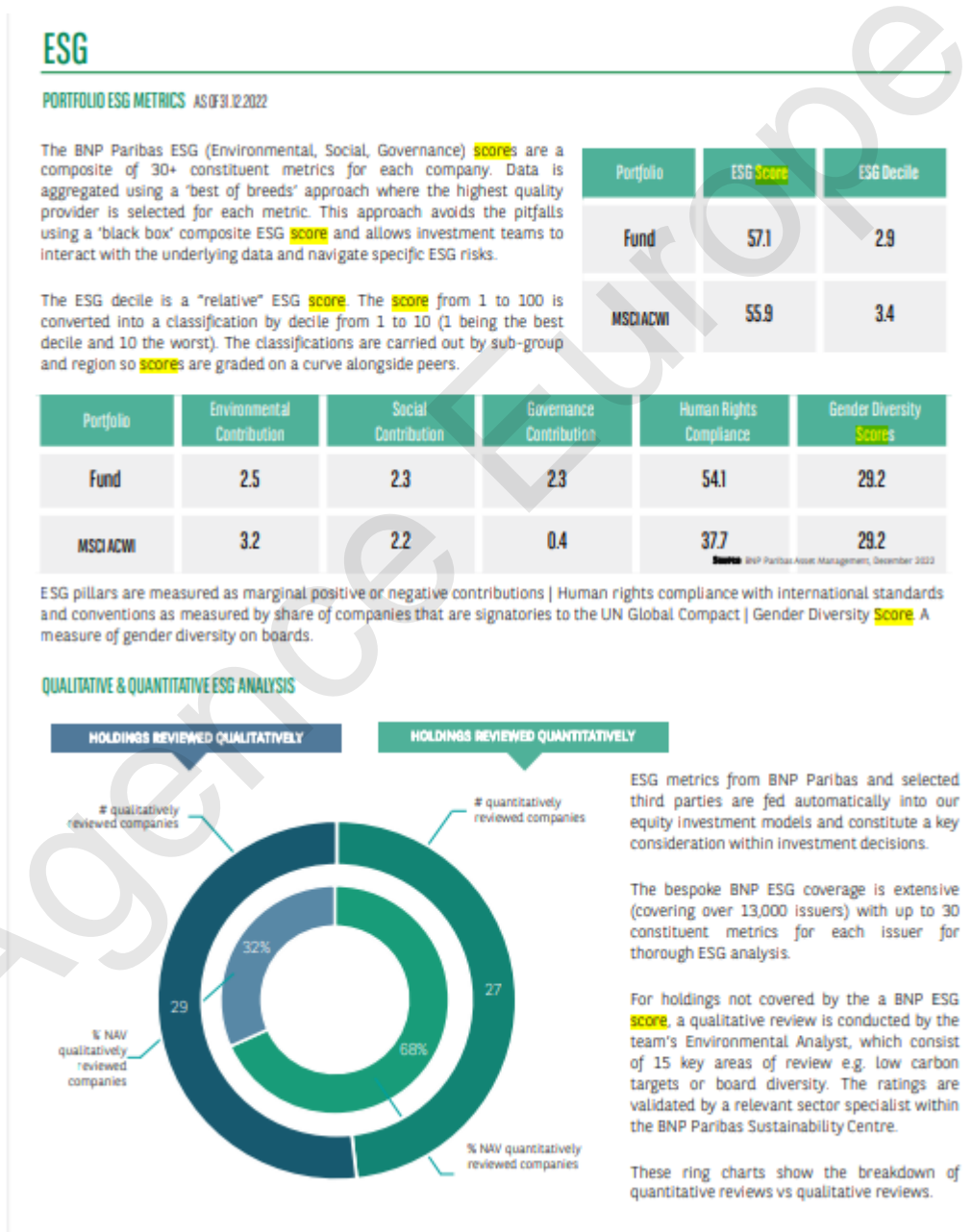
Figure 5 | Overview of Robeco's SDG-focused solutions

	Investment objective	Universe	Investment approach	SDG approach
RobecoSAM Global SDG Credits	Actively managed portfolios that provide long-term capital growth and align with and/or contribute to the UN Sustainable Development Goals	Investment grade high yield emerging market corporate bonds	Top-down macroeconomic analysis Bottom-up fundamental issuer analysis	Investing in companies with a 0, +1, +2, or +3 SDG score
RobecoSAM Euro SDG Credits		Euro-denominated investment grade corporate bonds		
RobecoSAM SDG Credit Income		Flexible exposure to HY, IG, EM corporate bonds		
RobecoSAM SDG High Yield Bonds		High yield global corporate bonds with sub-investment grade rating		
RobecoSAM QI Global SDG & Climate Multi-Factor Credits		Global corporate bonds	Quantitative bond selection model	Investing in companies with a 0, +1, +2, or +3 SDG score
RobecoSAM Global SDG Equities		Concentrated portfolio of global equities (all cap)	Bottom-up fundamental issuer analysis	Investing in companies with a +2, or +3 SDG score
RobecoSAM Global SDG Engagement				Investing in companies with -1, 0, or +1 SDG scores and engage with

II. Examples of financial product methodology disclosures on websites and in product documents:

Example 1

“Environment impact and climate report” document includes the high level overview of the methodology for in-house scores (e.g. information that the methodology is based on best in the class approach). The document explains that internal scores and third party scores are fed automatically into equity investment models and constitute one of key consideration within investment decisions. However, other information than a high level overview of the methodology for ESG scores couldn’t be found.



Example 2

“ESG and Impact Indicators Definitions and Methodology” document includes a very short information on the methodology, with the reference to a long set of publications (none of them referring to ESG ratings or scores in the title).

<p>ESG score</p>	<p>Score resulting from Candriam internal ESG analysis:</p> <ul style="list-style-type: none"> • For corporate issuers, analysis is done from two angles: analysis of the impacts of business activities (products and services) and management of companies' key stakeholders. • For sovereign issuers, it incorporates the 4 essential dimensions of sustainability: human capital, natural capital, social capital and economic capital. <p>More details on Candriam's ESG analysis methodology are available in the transparency code.</p>	<p>Score [0-100]</p>	<p>Candriam https://www.candriam.com/en/private/market-insights/sri-publications/#transparency</p>
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Example 3 - Example of disclosures in the financial product documents - SFDR disclosure includes two references to ESG scores:

<p>(c) Sustainable investment objective of the financial product</p>
<p>What is the sustainable investment objective of the financial product?</p>
<p>The Fund's sustainable investment objective is to advance the United Nations Sustainable Development Goals (UN SDGs) by investing in companies whose business models and operational practices are aligned with targets defined by the 17 UN SDGs.</p>
<p>The sustainability indicators towards meeting the sustainable investment objective are the following:</p>
<ol style="list-style-type: none"> 1. The number of companies with a positive SDG score based on the internally developed SDG Framework. 2. The % of investments in securities that are on Robeco's Exclusion list as result of the application of Robeco's Exclusion policy. 3. The % of holdings that are in violation of the ILO standards, UNGPs, UNGC or OECD Guidelines for Multinational Enterprises. 4. The number of holdings and agenda items.

<p>(f) Monitoring of sustainable investment objective</p>
<p>How are the sustainable investment objective and the sustainability indicators used to measure the attainment of the sustainable investment objective monitored throughout the lifecycle of the financial product and what are the related internal or external control mechanisms?</p>
<ol style="list-style-type: none"> 1. The second line of defense (Risk Management) excludes all companies with a SDG score less than 1 and facilitates pre-trade compliance. 2. All exclusions are coded in the Trading & Compliance module, through which investing in an excluded asset is not possible. In addition, post-trade checks take place. 3. All exclusions in relation to Controversial behavior are coded in the Trading & Compliance module, through which investing in an excluded asset is not possible. In addition, post-trade checks take place. 4. The proxy voting policy is reviewed on an annual basis, including voting principles in relation to ESG topics. Changes to the policy are presented to the Sustainability and Impact Strategy Committee. Voting behaviour on ESG topics are monitored in the first line. On an annual basis the implementation of the voting policy is tested as part of our ISAE framework.

The high overview of the methodology is provided in a separate document:

Quantifying a company's SDG contribution

Following the three-step assessment of the SDG framework, we **score** companies' impacts on each of the SDGs. The **scores** range from highly positive (+3) to highly negative (-3) (see Figure 2). A company may thus impact multiple SDGs, whereby each of these impacts may be positive or negative at various impact levels. Once a company's impacts on the 17 SDGs has been **scored**, its overall SDG **score** is calculated. This is done according to what we call the 'min-max' rule: a company without any negative **scores** on individual SDGs is assigned the highest (max) **score** as its overall SDG **score**. But if a company has a negative **score** on any of the SDGs, it will receive the lowest (min) **score** as its overall SDG **score**. The resulting company SDG **scores** can then be applied to investment screening and portfolio analysis within Robeco's SDG-focused investment products.

Agence Europe

Annex II

Requirements Annex III ESG ratings regulation:

1. MINIMUM DISCLOSURES TO THE PUBLIC

In accordance with Article 12 of the Regulation, ESG rating providers shall, at the minimum, disclose to the public on their website and through the European Single Access Point (ESAP) the following:

- (a) high level overview of the rating methodologies used (and changes thereto), including whether analysis is backward-looking or forward-looking;
- (b) high level overview of data processes (data sources, including if they are public or non-public, and if they are sourced from sustainability statements required by Directive (EU) 2022/2464, estimation of input data in case of unavailability, frequency of data updates);
- (c) information on whether and how the methodologies are based on scientific evidence;
- (d) information on the ratings' objective, clearly marking whether the rating is assessing risks, impacts or some other dimensions;
- (e) the rating's scope – i.e., is it an aggregated rating (aggregating E and S and G factor), or a rating of individual factors or specific issues (e.g., transition risks);
- (f) in the case of an aggregated ESG rating, weighting of the three overarching ESG factors categories (e.g., 33% Environment, 33% Social, 33% Governance), and the explanation of the weighting method, including weight per individual E, S and G factors;
- (g) within the E, S or G factors, specification of the topics covered by the ESG rating/score, and whether they correspond to the topics from the sustainability reporting standards developed pursuant to Article 29b of Directive 2013/34/EU;
- (h) information on whether the rating is expressed in absolute or relative values,
- (i) Where applicable, reference to the use of Artificial Intelligence (AI) in the data collection or rating/scoring process;
- (j) general information on criteria used for establishing fees to clients, specifying the various elements taken into consideration, such as the involvement of data analysts, IT equipment, purchasing data;
- (k) any limitation in data sources used for the construction of ESG ratings.