Attn Mr Sven Gentner
DG FISMA
European Commission
1049 Bruxelles

6 June 2022

Subject: response to call for evidence on ESG ratings and sustainability risk in credit ratings

Dear Mr Gentner,

PwC International Ltd (PwC), on behalf of the PwC network, welcomes the European Commission’s initiative to improve the quality and transparency of ESG ratings and sustainability risk in credit ratings.

ESG ratings play an important role in the corporate reporting system - although they should not be a proxy for good reporting by companies. ESG ratings improve the manageability of the information being used and help investors and other stakeholders understand the ESG risk and impact of companies and portfolios. A system-wide approach with clear roles and responsibilities of all participants is key to an effective regulatory environment. When designing the framework for ESG ratings, we recommend prioritising the delivery of high quality and trustworthy information to capital markets in order to support better investment decisions.

The global nature of capital markets and of sustainability risks make international alignment key to achieving truly more sustainable outcomes. The IOSCO Recommendations on ESG ratings and data products providers provide an appropriate global framework for regulating ESG ratings providers, which the European Commission could leverage to achieve consistency at international level.

Transparency of methodologies and minimum quality requirements

We agree with the European Commission’s proposal to introduce transparency and clarity around underlying methodologies and data sources utilised by ESG ratings providers. Both retail and institutional investors, as the primary users of ratings, should be able to assess how effective rating providers have been in evaluating a company, or whether the criteria selected align with their own sustainability objectives including with regard to how risk and/or impact materiality has been applied. Only in this way, users of ESG ratings would be able to make truly informed decisions and better integrate ESG ratings in their risk management systems.

The key function of ESG ratings also calls for minimum quality requirements for providers, including regarding internal quality control, corporate governance, as well as robust regulatory oversight.

Consistency between the sustainability reporting framework and ESG ratings

The quality, and therefore the usefulness, of the ESG ratings is directly dependent on the quality of the underlying data. A robust and globally consistent framework for disclosures by rated entities is critical to ensure that ratings are based on relevant, comparable and reliable data. From our experience, companies currently need to invest considerable resources into filling in questionnaires from some ESG rating agencies. The Corporate Sustainability Reporting Directive (CSRD) and related reporting standards should form the basis to streamline the data requested and used for ESG rating purposes. In addition, when ESG rating providers make use of other information than what is reported by the company, this should be clearly stated. The source and relevance of this information should be disclosed, including whether it is the provider's own estimate, so that users of the ratings are able to assess their reliability.

Furthermore, the reliance of ratings providers on the quality of the underlying data increases even more the need for a common global baseline for corporate sustainability reporting. We therefore encourage the EC to ensure that the proposed European Sustainability Reporting Standards under the CSRD contribute to, and are closely aligned with, the proposed international sustainability reporting standards[1]. This will ensure that consistent information can be collected and made available by companies with global value chains.

Using the CSRD as an information basis will also promote the development of a consistent and standardised approach for ESG ratings, which builds on assured and standardised information. This would not only facilitate compliance with ESG regulations by investors, but also reduce costs for issuers.

Consistency between investor disclosures, CSRD and ESG ratings

Our experience in supporting clients implementing the Sustainable Finance Disclosures Regulation (SFDR) showed that financial market participants rely to a large extent on ESG ratings when screening and disclosing information for sustainable investments under art. 8 and art. 9.

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[1] See here for our concrete suggestions on a way forward towards a common global baseline for corporate sustainability reporting

This ‘enabling’ function can help the whole capital markets community, especially if ESG ratings use transparent methodologies and standardised, high-quality data sources. However, this also greatly increases the need for consistency of ESG ratings with disclosures required by EU Sustainable Finance legislation across sectors (CSRD, Benchmarks Regulation, SFDR, Taxonomy Regulation), so that compliance is simplified, while investors and other beneficiaries are protected and can have consistent information to evaluate ESG performances. Due to the current lack of transparency and ‘black box’ feature of ESG ratings, investors using them cannot be confident about their accuracy and whether the rating really reflects the risk profile and ESG characteristics of the financial product.

Furthermore, ESG ratings play an important role in identifying and screening companies that are included in ESG benchmarks and indices. They can therefore strongly influence capital flows, especially from passive investment funds. Clear definitions and consistent rules are needed so that benchmarks that rely on ESG ratings can be transparent about which sustainable objectives they promote and can ensure respect of the ‘do no significant harm’ principle.

Sustainability risk in credit ratings

Under the current regulatory framework, all material risks to creditworthiness must be taken into account, including ESG risks if relevant. We recommend continuing to foster the interconnectivity between financial and sustainability information so that methodologies can be refined and an evidence base can be built to quantify the credit impact of sustainability risks. The importance of the risk-based and evidence-based approach was also underlined by the European Banking Authority in its work on ESG risks in the macroprudential framework.

We look forward to continuing to share our perspectives with EU legislators. If you would like to discuss any aspects of our response, please contact Hilary Eastman at hilary.s.eastman@pwc.com.

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Yours sincerely,
Gilly Lord
Global Leader, Public Policy and Regulation

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