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#### **COVER NOTE**

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From: Secretary-General of the European Commission, signed by Ms Martine DEPREZ, Director

date of receipt: 14 June 2023

To: Ms Thérèse BLANCHET, Secretary-General of the Council of the European Union

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Subject: Regulatory Scrutiny Board Opinion  
Environmental, social and governance (ESG) ratings and sustainability risks in credit ratings

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Delegations will find attached the document mentioned above.

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Encl.: SEC(2023) 241



EUROPEAN COMMISSION

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**REGULATORY SCRUTINY BOARD OPINION**

Environmental, social and governance (ESG) ratings  
and sustainability risks in credit ratings

{COM(2023) 314}

{SWD(2023) 204, 207}



EUROPEAN COMMISSION  
Regulatory Scrutiny Board

Brussels,  
RSB/

## **Opinion**

**Title: FISMA - Impact assessment / Environmental, social and governance (ESG) ratings and sustainability risks in credit ratings**

**Overall opinion: POSITIVE WITH RESERVATIONS**

### **(A) Policy context**

Environmental, Social and Governance (ESG) ratings cover how companies, products and financial instruments are exposed to environmental, social, and governance risks. This initiative is part of the 2021 Commission renewed sustainable finance strategy and aims to strengthen the reliability and comparability of ESG ratings. In doing so, it aims to complement existing Regulations on sustainable finance, most importantly the Sustainable Finance Disclosure Regulation, the Corporate Sustainability Reporting Directive and the EU Taxonomy Regulation.

### **(B) Summary of findings**

**The Board notes additional information provided and commitments to make changes to the report.**

**However, the report still contains significant shortcomings. The Board gives a positive opinion with reservations because it expects the DG to rectify the following aspects:**

- (1) The report does not sufficiently substantiate, with evidence, the analysis of impacts across the policy options.**

### **(C) What to improve**

(1) The report should more explicitly explain the scale of the problems identified. It should more clearly distinguish between specific problems and general context and between the presented problems and their drivers. The report should also, in the problem description, set out how the current ESG ratings affect the allocation of capital towards specific investments. Building on a clarified problem structure, it should give a clearer idea of what success would look like for this initiative, through clearly structured general objectives and more detailed specific objectives.

This opinion concerns a draft impact assessment which may differ from the final version.

(2) The report should better outline what the key elements of the options presented are and discuss whether there are other possible combinations of options. It should clarify whether there are possible sub-options among the key elements under the preferred option for regulatory treatment of ESG rating providers. In addition, the report should explain in more detail at what stage and how 'level 2' implementing measures will be assessed and better outline the anticipated impact, such as the administrative costs from new disclosure requirements. If no further dedicated cost benefit analysis will be carried out at later stage, the report should provide ranges of estimates for all new requirements.

(3) The report should better describe the structure and range of the available options concerning the incorporation of ESG factors into credit ratings. Beyond the impact of timing, the report should also clarify what the other justifications for appropriate policy choices are.

(4) The report should better substantiate with evidence how the different options will meet the specific objectives and address the identified problems. Furthermore, it should describe how and to what extent the options will contribute to a decreased cost of due diligence for rated companies and ESG rating users. It should also better explain how the preferred option will lead to improved allocation of circa EUR 11 trillion of ESG investment.

(5) The report should better describe what the costliest authorisation aspects are, to provide a more precise comparison of options and proportionality analysis. Where it is not possible to provide further quantification, the report should be clear on the data limitations.

The Board notes the estimated costs and benefits of the preferred option(s) in this initiative, as summarised in the attached quantification tables.

*Some more technical comments have been sent directly to the author DG.*

**(D) Conclusion**

**The DG must revise the report in accordance with the Board's findings before launching the interservice consultation.**

**If there are any changes in the choice or design of the preferred option in the final version of the report, the DG may need to further adjust the attached quantification tables to reflect this.**

Full title	Environmental, social and governance (ESG) ratings and sustainability risks in credit ratings Impact assessment on ESG ratings and sustainability risks in credit ratings
Reference number	PLAN/2021/12801
Submitted to RSB on	17 November 2022
Date of RSB meeting	Written procedure

**ANNEX: Quantification tables extracted from the draft impact assessment report**

The following tables contain information on the costs and benefits of the initiative on which the Board has given its opinion, as presented above.

If the draft report has been revised in line with the Board's recommendations, the content of these tables may be different from those in the final version of the impact assessment report, as published by the Commission.

a) Summary of costs and benefits

<b>I. Overview of Benefits (total for all provisions) – Preferred Option</b>		
<i>Description</i>	<i>Amount</i>	<i>Comments</i>
<i>Direct benefits</i>		
Reduction of due diligence costs for rating users and rated entities	This will be reflected in fewer resources needed by users or rated entities to get the same level of understanding of the ESG ratings in the market and their methodologies, as well as clarity on the sound operations of the ESG rating provider. It is challenging to estimate the size of this impact, but we can consider the following hypothetical example: assuming that each asset manager in the EU would save 0.5-1.3 FTEs due to the additional transparency, it would translate into cost savings of approximately EUR 110-290 million <sup>1</sup> . The total savings would likely be higher considering that other user groups would also benefit.	<u>Who benefits:</u> ESG rating users (investors, companies and other users), rated entities  Users and rated entities will have an improved understanding of the ESG rating characteristics and their methodologies, and of the operations of ESG ratings providers.
More informed choice of ESG rating provider and more effective engagement with ESG rating provider	Not possible to quantify but can be partially covered by estimate in first row; part would be in addition.	<u>Who benefits:</u> ESG rating users (investors, companies and other users), rated entities  Differences between ESG ratings (objective, factors/KPIs considered, weights, etc.) become more explicit and users – or potential users - will be better able to compare

<sup>1</sup> This example is based on the responses of more than 20 asset managers. While most of them only provided qualitative information and there were some outliers, most expected rather large savings from greater transparency on ESG rating methodologies. Indicative expected savings in FTEs from those who provided figures pointed at approximately 1.5-4 fewer FTEs being needed for due diligence on ESG ratings, reflecting the large resources dedicated to this presently. In the hypothetical example, we conservatively work with just one third of this estimate to account for smaller or less ESG-focused asset managers who would likely have lower cost savings. We work with an approximate number of asset managers in the EU based on EFAMA and Statista figures. Note that these cost savings can't be linked to EU legislation and are hence not considered to be relevant for "one in, one out" off-setting.

		rating products of different ESG rating providers, thus being able to make more informed choices of the products best suited for their purposes. Similarly, entities wishing to be rated can make more informed choices of rating provider. In terms of operations, users and rated entities can select the ESG rating providers with the business model and management of conflict of interest that they deem sufficient. Users and rated entities can also engage with ESG rating providers more effectively, being able to challenge certain methodological choices as needed. Users would better understand the limitations of ESG ratings and increased granularity of disclosures would allow them to prioritise additional analyst focus into cases where they consider data quality to be low. This would therefore increase efficiency of their investment processes.
<b>Indirect benefits</b>		
Increase in quality of ESG ratings	Not possible to quantify directly but see final row for size of investment pool which could benefit.	<p><u>Who benefits:</u> ESG rating users (investors, companies and other users), rated entities</p> <p>Quality of ESG ratings is expected to gradually increase as a result of greater oversight and transparency, as well as more effective engagement of users and rated entities with ESG rating providers. Market pressures would be expected to lead to a reduction in rating biases and in risks of conflict of interest. Further, users such as asset managers would make more efficient use of their external data budgets by selecting the right providers, and even in some cases using fewer providers than they otherwise do to ensure benchmarking for quality. The precise savings would depend on each user.</p>
Higher fitness for purpose	Not possible to quantify but see final row for size of investment pool which could benefit.	<p><u>Who benefits:</u> ESG rating users (investors, companies and other users), rated entities</p> <p>ESG ratings are expected to gradually become more fit for purpose to enable investors and rated companies to take informed decisions as regards ESG-related risks, impacts and opportunities. Users will also better understand the limitations of ESG ratings so they use them appropriately. A deeper understanding of the comparability and differences that lead to lack of correlation between different providers, could potentially expose the redundancies in using multiple providers, or conversely justifying the use of different providers in different contexts. This in turn would help with efficiency in external data budgets of users.</p>
Higher trust in ESG ratings	Not possible to quantify, but see final row for size of investment pool which could benefit.	<p><u>Who benefits:</u> ESG rating users (investors, companies and other users), rated entities, society at large</p> <p>Higher (perceived) quality, reliability and accuracy are expected to lead to higher trust in ESG ratings, which is also ultimately expected to fuel growth of the ESG ratings market.</p>

		The growth in the market could also lead to an increase in coverage of rated entities, including those who currently find it difficult or too costly to be rated. <sup>2</sup>
More sustainable EU economy	According to EFAMA statistics, by the end of Q1 2021, asset managers in Europe applied an ESG investment approach to circa EUR 11 trillion of assets. An improvement in allocation of these EUR 11 trillion could have a significant positive impact on ESG objectives.	Who benefits: society at large  The higher trust in ratings and their higher usefulness/fitness for purpose, could lead to better allocation of capital with regards to its contribution to ESG objectives or avoidance of ESG risks and more sustainable investment. Similarly, as investors increasingly value and trust ESG ratings, this would be expected to encourage rated entities to adopt sustainable practices. Moreover, with the greater transparency of rating methodologies, rated entities would be enabled to do so.
<i>Administrative cost savings related to the 'one in, one out' approach *</i>		
n/a	n/a	n/a

II. Overview of costs – Preferred option							
		Users and rated companies		ESG rating providers		Supervisors	
		One-off	Recurrent	One-off	Recurrent	One-off	Recurrent
Authorisation, principle-based organisational requirements and risk-based supervision	Direct adjustment costs	n/a	n/a	One-off adjustment costs may arise e.g., due to the need to upgrade IT systems or strengthening of internal procedures and familiarisation with the new rules (e.g., legal and consultancy costs). Data that would allow to provide an estimate were very limited and the impact would greatly depend on the readiness and complexity of the provider.	Recurring adjustment costs may arise, e.g. running a strengthened internal control and compliance function and maintenance of IT systems. Data that would allow to provide an estimate were very limited and the impact would greatly depend on the readiness and complexity / governance of the provider. Possible further cost related to changes to the business models, where ESG rating providers do not sufficiently separate business activities or do not have policies in place against conflict of interest. These would be very provider-specific and we do not have	n/a	n/a

<sup>2</sup> Note that in the first years of application, it is possible that we see a temporary decline in the market due to the effect of new rules (adaptation of providers, new costs, etc.).

					sufficient data to estimate the size of impact or number of providers impacted.		
	Direct administrative costs	n/a	n/a	Applying for authorisation: preparing and submitting relevant documents would imply an approximate magnitude of costs of EUR 68 000 – 108 000 per provider and EUR 4 - 6.4 million in total.	Costs are expected to arise from ongoing interaction with supervisor and responding to their information requests and estimated at an approximate total magnitude of EUR 6.7 – 10.6 million <sup>3</sup> . Costs of interaction with the supervisor are expected to be proportionate between entities, as risk-based supervision focuses more effort on larger players in a given market <sup>4</sup> .	n/a	n/a
	Direct regulatory fees and charges	n/a	n/a	n/a	Supervisory fees – sliding scale ranging between 0.37% of revenues for smallest providers and 2.4% of revenues for the largest providers <sup>5</sup> .	n/a	n/a
	Direct enforcement costs	n/a	n/a	n/a	n/a	Costs for ESMA to assess applications for authorisation.	Ongoing supervision of ESG rating providers by ESMA will imply further resource needs. The total

<sup>3</sup> This estimate is subject to relatively larger uncertainty as the Commission services have attempted to get estimates for these costs, but only few entities provided specific figures and the intensity of supervision (i.e. number of supervisory reviews in a certain number of years or how many additional documents would be asked for by the supervisor) is not yet fully clear. Some of the figures that have informed this estimate were derived by subtracting estimated cost of disclosure from the total recurring compliance that some providers indicated rather than a self-standing figure for dealing with the supervisor.

<sup>4</sup> The effort level assumed in this estimate based on stakeholder responses greatly varies by size and corresponds to about 0.8-1.1 FTEs per smaller provider vs almost 4-7 FTEs for larger providers.

<sup>5</sup> Based on a preliminary assessment provided by ESMA. The figures are subject to uncertainty as ESMA's estimation only considered providers where revenue information was available. This estimate covers also the cost of enforcing disclosure rules and the cost for ESMA to grant authorisations to market participants, where the latter may be charged through a one-time authorisation fee.



						(reflected in the supervisory fee detailed above)	annual cost increase is estimated at approximately EUR 5.7 million annually <sup>6</sup> . Such costs would be fully financed through supervisory fees paid by ESG rating providers (detailed under "Direct regulatory fees and charges").
	Indirect costs	n/a	Possible pass-through of fees and other recurring costs to users of ESG ratings or rated entities, depending on business model.	n/a	n/a	n/a	n/a
Minimum transparency towards	Direct adjustment costs	n/a	n/a	Part of the potential upgrade of IT systems (see above) may also be attributed to disclosure obligations. <sup>7</sup> Providers were not	Part of the strengthening of the compliance function or IT maintenance (see above) may also be attributed to disclosure obligations. <sup>8</sup>	n/a	n/a

<sup>6</sup> This figure is a result of estimation by ESMA calibrated based on available data on the market, as the intensity of supervision and hence costs for the supervisor are expected to differ based on provider size, consistent with the risk-based supervision approach. The figure includes labour costs, overheads as well as relevant IT costs. As data on revenues from ESG ratings were available only for some providers, assumptions were used to extrapolate the estimate to the whole market in order to estimate total resource needs for ESMA and the corresponding supervisory fees to cover these costs.

<sup>7</sup> According to some of the interviewed ESG ratings providers.

<sup>8</sup> According to some of the interviewed ESG ratings providers.

the public and more comprehensive disclosures to clients of ESG rating providers and rated companies				able to clearly separate the two costs. Further costs would stem also from the need to become familiar with the new rules (e.g. legal and consultancy costs).	Providers were not able to clearly separate the two costs.		
	Direct administrative costs	n/a	n/a	One-off cost of disclosing information: collecting relevant data and describing characteristics and methodologies of ESG ratings and operations of ESG rating providers. If relevant policies/frameworks do not exist internally, these may have to be prepared from scratch. Total estimated in the approximate range of EUR 7 500 – 15 000 per provider and EUR 440 - 880 thousand in total <sup>9</sup> .	Ongoing cost of disclosures: annual updates of information on ESG rating and operations of ESG rating providers and related compliance checks. Estimated in the approximate range of EUR 13 000 – 29 000 per provider and EUR 770 thousand to 1.7 million in total.	n/a	n/a
	Direct regulatory fees and charges	n/a	n/a	n/a	n/a	n/a	n/a
	Direct enforcement costs	n/a	n/a	n/a	n/a	n/a	Additional resource needs for ESMA in order to enforce the rules on disclosures. There would be part of the estimate presented above and are paid for by the supervisory fees

<sup>9</sup> We note that the one-off costs as estimated from stakeholder feedback are lower than recurring costs. Our assumption is that, if we wanted to obtain the total cost of preparing disclosures for the first time, we would need to add the one-off cost element to the recurring cost detailed in the next cell.

							detailed further above in the table)
	Indirect costs	n/a	Possible pass-through of disclosure costs to users of ESG ratings or rated entities, depending on business model.	n/a	n/a	n/a	n/a
<i>Costs related to the 'one in, one out' approach</i>							
<b>Total</b>	Direct adjustment costs	n/a	n/a	n/a	Adapting business models to comply with rules to avoid conflict of interest and other obligations.		
	Indirect adjustment costs	n/a	Possible pass-through of costs by ESG rating providers to users of ESG ratings or rated entities.	Possible further costs related to update of IT systems or organisational changes.	Possible further costs related to strengthened internal control and compliance function and maintenance of IT systems.		
	Administrative costs (for offsetting)	n/a	n/a	One-off cost in the approximate magnitude of EUR 4.5 – 7.3 million. These consist of the one-off cost of disclosures: approximate total of EUR 440 - 880 thousand and the cost of applying for authorisation: approximate total of EUR 4 - 6.4 million.	On-going administrative costs in the approximate magnitude of EUR 7.5-12.3 million. These consist of the on-going cost of disclosures (approximate total of EUR 770 thousand to 1.7 million) and costs of ongoing interaction with supervisor (approximate total of EUR 6.7-10.6 million).		