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From:	Ms Christine LAGARDE, President of the European Central Bank
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To:	Ms Thérèse BLANCHET, Secretary-General of the Council of the European Union
Subject:	Opinion of the European Central Bank of 4 October 2023 on the transparency and integrity of Environmental, Social and Governance (ESG) rating activities

Delegations will find enclosed the ECB opinion mentioned above, which the ECB has decided to deliver at its own initiative

This Opinion will be published on EUR-Lex.

Encl.

EUROPEAN CENTRAL BANK

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OPINION OF THE EUROPEAN CENTRAL BANK

of 4 October 2023

on the transparency and integrity of Environmental, Social and Governance (ESG) rating activities

(CON/2023/30)

Introduction and legal basis

On 13 June 2023, the European Commission published a proposal for a regulation on the transparency and integrity of Environmental, Social and Governance (ESG) rating activities[1] (hereinafter the 'proposed regulation').

The European Central Bank (ECB) has decided to deliver an own initiative opinion on the proposed regulation. The ECB's competence to deliver an opinion is based on Articles 127(4) and 282(5) of the Treaty on the Functioning of the European Union (TFEU), since the proposed regulation contains provisions affecting (1) the basic task of the European System of Central Banks (ESCB) to define and implement the monetary policy of the Union pursuant to Article 127(2) of the Treaty, (2) the ECB's tasks concerning the prudential supervision of credit institutions pursuant to Article 127(6) of the Treaty, and (3) the ESCB's contribution to the smooth conduct of policies pursued by the competent authorities relating to the stability of the financial system, as referred to in Article 127(5) of the Treaty.

In accordance with the first sentence of Article 17.5 of the Rules of Procedure of the European Central Bank, the Governing Council has adopted this opinion.

1. General observations

1.1 The ECB welcomes the proposed regulation, which introduces a common regulatory approach to enhance the adequacy, integrity, transparency, responsibility, good governance, and independence of ESG rating activities, contributing to the transparency and quality of ESG ratings. The ECB strongly supports the objective of the proposed regulation to contribute to the smooth functioning of the internal market, while achieving high levels of consumer and investor protection and preventing greenwashing and other types of misinformation, by introducing transparency requirements related to ESG ratings and rules on the organisation and conduct of ESG rating providers[2].

1.2 The proposed regulation is an integral part of the Commission's broader sustainable finance strategy[3]. The attainment of the objectives laid out in the European Green Deal[4] and in the Paris

1 COM(2023) 314 final.

2 See Article 1 of the proposed regulation.

3 Communication from the Commission on the Strategy for Financing the Transition to a Sustainable Economy COM(2021) 390 final.

4 The Commission published its communication on 'The European Green Deal' on 11 December 2019; see COM(2019) 640 final.

Agreement[5] and enshrined in Regulation (EU) 2021/1119 of the European Parliament and of the Council (the 'European Climate Law')[6] depends on the contribution of all economic stakeholders[7] and requires significant investment, a substantial part of which will need to come from the private sector[8]. Sustainable finance, and particularly the proposed regulation, can play an important role in this respect by enabling investors to identify environmentally sustainable investments and adjust their portfolios according to their own sustainability preferences.

1.3 Through the abovementioned channels, the proposed regulation is expected to contribute to the further development of an integrated, deep and liquid Union green capital market, in turn advancing the Capital Markets Union more broadly[9]. Building mature and integrated Union green capital markets will require efforts to strengthen capital markets, including greater harmonisation of supervision and investor protection. In this regard, the ECB welcomes that the European Securities and Markets Authority (ESMA) will be tasked with supervising ESG ratings providers.

2. Relevance of the proposed regulation for the objectives and tasks of the ECB and the Eurosystem

Sustainability-related issues, and in particular climate change, can impact the manner in which central banks discharge their mandates[10], in particular due to their relevance for monetary policy, financial stability and the prudential supervision of credit institutions.

2.1 *Relevance for monetary policy*

2.1.1 Climate change and the transition towards a more sustainable economy affect the outlook for price stability, the primary objective of the ESCB, through their impact on macroeconomic indicators such as inflation, output, employment, interest rates, investment and productivity; financial stability; and the transmission of monetary policy[11]. Physical risks and transition risks associated with climate change can, inter alia, impact the valuations and creditworthiness of companies with knock-on effects for credit institutions and the financial system[12]. Although methodologies to assess the magnitude of climate-related risks for banks and financial stability are still being developed, available estimates

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5 Paris Agreement adopted under the United Nations Framework Convention on Climate Change (OJ L 282, 19.10.2016, p. 4).

6 Regulation (EU) 2021/1119 of the European Parliament and of the Council of 30 June 2021 establishing the framework for achieving climate neutrality and amending Regulations (EC) No 401/2009 and (EU) 2018/1999 ('European Climate Law') (OJ L 243, 9.7.2021, p. 1).

7 Communication from the Commission on the Strategy for Financing the Transition to a Sustainable Economy COM(2021) 390 final.

8 See also the explanatory memorandum to the proposed regulation.

9 See 'Towards a green capital markets union for Europe', speech by Christine Lagarde, President of the ECB, at the Commission's high-level conference on the proposal for a Corporate Sustainability Reporting Directive, Frankfurt am Main, 6 May 2021, available on the ECB's website at www.ecb.europa.eu.

10 See paragraph 2.4 of Opinion CON/2021/12 of the European Central Bank of 19 March 2021 on the mandate and tasks of the Magyar Nemzeti Bank relating to environmental sustainability, and paragraph 2 of Opinion CON/2021/27 of the European Central Bank of 7 September 2021 on a proposal for a directive amending Directive 2013/34/EU, Directive 2004/109/EC, Directive 2006/43/EC and Regulation (EU) No 537/2014, as regards corporate sustainability reporting (OJ C 446, 3.11.2021, p. 2). All ECB opinions are available on EUR-Lex.

11 See press release 'ECB presents action plan to include climate change considerations in its monetary policy strategy', 8 July 2021, available on the ECB's website at www.ecb.europa.eu.

12 See 'Climate-related risks to financial stability', Special Feature in ECB Financial Stability Review, May 2021, available on the ECB's website at www.ecb.europa.eu.

suggest that the impact of these risks is likely to be significant[13]. This, in turn, could affect the transmission of monetary policy, for example via the stranding of assets and the sudden repricing of climate-related financial risks. Moreover, with regard to the banking sector, the value of collateral may decrease, and credit losses may materialise, which could dent the capital and liquidity position of credit institutions and other financial intermediaries, thereby weakening their ability to channel funds to the real economy. The Network of Central Banks and Supervisors for Greening the Financial System (NGFS) recommends, therefore, that central banks consider the possible effects of climate change on the economy. The NGFS argues that these effects may be relevant to monetary policy even if they only materialise beyond the conventional medium-term horizon of monetary policy[14].

2.1.2 Furthermore, when pursuing its objective of maintaining price stability and carrying out its task of defining and implementing the monetary policy of the Union, the Eurosystem must respect the requirement set out in Article 18.1, second indent, of the Statute of the European System of Central Banks and of the European Central Bank (hereinafter the 'Statute of the ESCB') to lend against adequate collateral. Similar risk management considerations apply to outright purchases of claims and marketable instruments conducted pursuant to Article 18.1, first indent, of the Statute of the ESCB. Therefore, in its monetary policy operations the Eurosystem should aim to avoid losses and should ensure adequate risk protection of its balance sheet through, inter alia, its risk control framework. The Eurosystem accordingly needs to identify, monitor and mitigate the risks, including climate-related financial risks, that are associated with the collateral it accepts in its liquidity-providing credit operations, and its holdings of assets purchased under outright transactions. These risks can affect the value of the assets accepted as collateral by central banks or held in their outright portfolios for monetary policy purposes. Moreover, the need to manage such risks is also relevant for the Eurosystem's non-monetary policy portfolio.

2.1.3 Furthermore, pursuant to Articles 127(1) and 282(2) TFEU, as reflected in Article 2 of the Statute of the ESCB, without prejudice to the objective of price stability, the Eurosystem shall support the general economic policies in the Union with a view to contributing to the achievement of the objectives of the Union, as laid down in Article 3 of the Treaty on European Union. These objectives include a high level of protection and improvement of the quality of the environment. The European Climate Law sets out a binding objective of climate neutrality in the Union by 2050 in pursuit of the long-term temperature goal set out in the Paris Agreement. As the European Climate Law affects every conceivable aspect of economic policy in the Union, it forms part of the general economic policies in the Union, which the ECB is required to support.

2.1.4 In the light of the above, as outlined in the Governing Council's monetary policy strategy review and accompanying climate-related action plan that was published on 8 July 2021[15], when adjusting its monetary policy instruments, the ECB will choose the configuration that best supports the general

13 See paragraph 2.4 of Opinion CON/2021/12; paragraph 2.2 of Opinion CON/2021/22 of the European Central Bank of 11 June 2021 on the regulation of the forint maturity mismatch of credit institutions; and Isabel Schnabel, 'Never waste a crisis: COVID-19, climate change and monetary policy', virtual roundtable on 'Sustainable Crisis Responses in Europe', INSPIRE research network, 17 July 2020, available on the ECB's website at www.ecb.europa.eu.

14 See paragraph 2.4 of Opinion CON/2021/12; and page 3 of 'Climate change and monetary policy: initial takeaways', June 2020, available on the Network of Central Banks and Supervisors for Greening the Financial System's website at www.ngfs.net.

15 Available on the ECB's website at www.ecb.europa.eu.

economic policies in the Union, provided that two configurations of the instrument set are equally conducive and not prejudicial to price stability.

2.1.5 In this respect, the establishment of regulatory standards to ensure transparent and high quality ESG ratings is likely to accelerate improvements in the quality of environmental disclosures and data in more general terms. These developments would in turn enhance the Eurosystem's capability to incorporate climate change considerations into the definition and implementation of monetary policy.

2.2 *Application of the proposed regulation to central banks*

2.2.1 Recital 15 of the proposed regulation provides that ESG ratings developed by European or national authorities and by central banks should be exempt from the rules on ESG rating providers. The substantive provision laying down the exemption sets out that the proposed regulation does not apply to ESG ratings produced by central banks that fulfil all of the following conditions: (a) they are not paid for by the rated entity; (b) they are not disclosed to the public; (c) they are provided in accordance with the principles, standards and procedures which ensure the adequacy, integrity and independence of rating activities, as provided for by the proposed regulation; and (d) they do not relate to financial instruments issued by the respective central banks' Member States[16].

2.2.2 The ECB welcomes the inclusion of an exemption for central banks from the scope of the proposed regulation, as this may support the Eurosystem's actions to incorporate climate change considerations in the conduct of its monetary policy, and in particular into its collateral framework for liquidity-providing credit operations[17]. This is particularly relevant at the current juncture, where the availability, transparency and quality of ESG ratings produced by commercial ESG ratings providers is not yet adequate for use by central banks. Therefore, at least temporarily, it is necessary for central banks to be able to develop and apply their own assessment methodologies for some aspects of ESG factors, in particular climate considerations, that are tailored to and appropriate for the Eurosystem's needs in the pursuit of its monetary policy objectives.

2.2.3 Such methodologies can be of relevance for Eurosystem liquidity-providing credit operations. As noted above, these operations are an integral part of the Eurosystem's monetary policy framework and must be secured by 'adequate collateral' in accordance with Article 18.1 of the Statute of the ESCB to protect the Eurosystem against financial losses related to counterparty risk[18]. In addition, in accordance with Article 18.2 of the Statute of the ESCB, the ECB must establish general principles for open market and credit operations carried out by itself or the national central banks, including for the announcement of conditions under which they stand ready to enter into such transactions. These conditions include public rules on certain risk control measures, to which eligible assets mobilised as collateral are subject[19]. In the same vein, all marketable eligible assets are listed in the Eurosystem eligible asset database, which is published on the ECB's website and updated by the ECB on a daily

16 See Article 2(2), point (i), of the proposed regulation.

17 See press release of 4 July 2022, 'ECB takes further steps to incorporate climate change into its monetary policy operations', available on the ECB's website at www.ecb.europa.eu.

18 See recital 18 of Guideline (EU) 2015/510 of the European Central Bank of 19 December 2014 on the implementation of the Eurosystem monetary policy framework (ECB/2014/60) (OJ L 91, 2.4.2015, p. 3).

19 See, in particular, Guideline (EU) 2015/510 (ECB/2014/60) (OJ L 91, 2.4.2015, p. 3) and Guideline (EU) 2016/65 of the European Central Bank of 18 November 2015 on the valuation haircuts applied in the implementation of the Eurosystem monetary policy framework (ECB/2015/35) (OJ L 14, 21.1.2016, p. 30).

basis, with a view to providing transparency to its monetary policy counterparties and ensuring the operational effectiveness of the framework.

2.2.4 Following the ECB's monetary policy strategy review, and the accompanying climate-related action plan that was published on 8 July 2021[20], the ECB announced several measures to take climate-related considerations into account in its collateral framework for liquidity-providing credit operations. These measures include introducing limits on the mobilisation of certain assets issued by entities with a high carbon footprint that can be pledged as collateral by individual counterparties and linking collateral eligibility to the compliance of issuers of mobilised assets with provisions of Union law on sustainable finance[21].

2.2.5 These measures will be undertaken in pursuit of the Eurosystem's primary objective of maintaining price stability and to support the general economic policies in the Union, without prejudice to the objective of price stability. The ECB understands that the aim of the proposed regulation is to introduce requirements for ESG ratings providers operating on a commercial basis, and that it is not intended to apply to Eurosystem central banks' monetary policy implementation measures. This is evidenced by the broad exemption for central banks referred to in recital 15 of the proposed regulation and the fact that the proposed regulation defines ESG ratings providers as legal persons whose occupation includes the offering and distribution of ESG ratings or scores on a professional basis, i.e. on a commercial basis[22]. However, depending on their design, once the Eurosystem discloses the result of applying its methodology to identify issuers or assets becoming subject to such measures, there is a risk that this disclosure may be perceived as falling within the broad definition of 'ESG ratings' set out under the proposed regulation[23]. In this context, the ECB notes that the current drafting of the exemption for ESG ratings produced by central banks appears unintentionally to have an unnecessarily narrow scope, which conflicts with the exercise of the Eurosystem's competences under the Treaties.

2.2.6 First, the condition of the exemption, which requires that central banks' 'ESG ratings' are 'not disclosed to the public'[24], would appear to impede the Eurosystem's ability to communicate to its monetary policy counterparties through its publicly accessible eligible assets database the conditions under which the Eurosystem stands ready to enter into liquidity-providing credit operations in accordance with Article 18.2 of the Statute of the ESCB. This ultimately also impedes the Eurosystem's ability to conduct monetary policy operations in a transparent and efficient manner.

2.2.7 Second, the ECB notes that the Eurosystem's climate-related measures could and would be designed and provided in a manner compatible with the overriding spirit of the principles, standards and procedures that ensure the adequacy, integrity and independence of rating activities[25], as

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20 Available on the ECB's website at www.ecb.europa.eu.

21 See press release of 4 July 2022, 'ECB takes further steps to incorporate climate change into its monetary policy operations', available on the ECB's website at www.ecb.europa.eu.

22 See Article 3(2) of the proposed regulation.

23 Article 3(1) of the proposed regulation defines 'ESG rating' as 'an opinion, a score or a combination of both, regarding an entity, a financial instrument, a financial product, or an undertaking's ESG profile or characteristics or exposure to ESG risks or the impact on people, society and the environment, that are based on an established methodology and defined ranking system of rating categories and that are provided to third parties, irrespective of whether such ESG rating is explicitly labelled as "rating" or "ESG score"'.

24 See Article 2(2), point (i)(b), of the proposed regulation.

25 See Article 2(2), point (i)(c), of the proposed regulation.

provided for in the proposed regulation[26]. However, the ECB notes that several provisions of the proposed regulation[27] are solely relevant and appropriate in respect of ESG ratings providers operating on a commercial basis. As such, the condition of the exemption set out in the proposed regulation, which requires that central banks' 'ESG ratings' are 'provided in accordance with the principles, standards and procedures which ensure the adequacy, integrity and independence of rating activities'[28], is not appropriate or relevant for central banks pursuing their statutory tasks.

2.2.8 In the event that the Eurosystem cannot avail itself of the exemption for the reasons outlined above, this could mean that part of the definition and implementation of the Eurosystem's monetary policy, in particular that part of the Eurosystem's collateral framework that seeks to address climate-related considerations, may be subject to authorisation and supervision by ESMA. Given that Eurosystem collateralised lending and outright purchases are core instruments for the implementation of monetary policy, such a consequence would not be compatible with the principle of central bank independence under Article 130 TFEU and Article 7 of the Statute of the ESCB, or with the competence of the Eurosystem to conduct the monetary policy of the Union[29].

2.2.9 Moreover, the ECB notes that such a consequence would not contribute to the achievement of the objectives of the proposed regulation to enhance consumer and investor protection and prevent greenwashing and other types of misinformation. Unlike ESG ratings produced by ESG ratings providers operating on a commercial basis, the Eurosystem's measures are designed to fulfil its Treaty-based objectives by ensuring price stability through the conduct of monetary policy by lending against adequate collateral, protecting its balance sheet and supporting the general economic policies in the Union. Due to this essential difference in climate performance assessments produced by central banks, compared to ESG ratings issued by commercial ESG rating providers, the ECB considers that ESCB central banks should be exempted in a manner similar to the exemption afforded to ESG ratings produced by all other Union or Member State public authorities under the proposed regulation[30], as already reflected in recital 15 of the proposed regulation. In particular, there does not appear to be any reason for treating 'ESG ratings' produced by central banks any differently from ESG ratings produced by Union or Member State public authorities or for treating members of the ESCB less favourably compared to regulated financial undertakings in the Union that use ESG ratings for internal purposes[31], both of which are fully and unconditionally exempt from the application

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26 See, for example, Article 130 TFEU; and Articles 7 (independence), 36 (staff) and 37 (professional secrecy) of the Statute of the ESCB. See also Guideline (EU) 2021/2253 of the European Central Bank of 2 November 2021 laying down the principles of the Eurosystem Ethics Framework (ECB/2021/49) (OJ L 454, 17.12.2021, p. 7), and the ethics framework of the ECB (OJ C 204, 20.6.2015, p. 3), in particular Part 0 of the ECB Staff Rules as regard the ethics framework (OJ C 375, 6.11.2020, p. 25).

27 See, for example, the following provisions of the proposed regulation: Article 15, which prohibits ESG rating providers from providing other activities (such as the provision of consulting to investors or undertakings, issuing and selling credit ratings, investment activities, audit activities); Article 23(3), which concerns supervision by ESMA in respect of a risk of a conflict of interest within an ESG rating provider due to the ownership structure, controlling interests, or activities of that ESG rating provider; and Article 25, which concerns fees charged by ESG rating providers to their clients.

28 See Article 2(2), point (i)(c), of the proposed regulation.

29 See Article 127(1) and (2), and Article 282 TFEU.

30 See Article 2(2), point (g), of the proposed regulation.

31 Article 2(2), point (b), of the proposed regulation provides an exemption for 'ESG ratings produced by regulated financial undertakings in the Union that are used for internal purposes or for providing in-house financial services and product'.

of the proposed regulation. The ECB recommends that the proposed regulation is amended accordingly.

2.3 *Relevance for financial stability*

2.3.1 The ECB supports the aim of the proposed regulation to strengthen the reliability and comparability of ESG ratings. Strengthening the reliability and comparability of ESG ratings will be key to facilitating efficient market pricing, in line with the principle of an open market economy, and thus supporting financial stability, for the reasons outlined below. It will also enhance the ECB's capability to monitor and address the impact of climate change on financial stability.

2.3.2 First, the comparability of ESG ratings across a growing number of providers is currently limited. This is due to several factors, including methodological differences, amid a sizeable growing market for sustainable finance instruments. ESG ratings can have meaningful effects on holdings of assets and on returns on assets because they may directly influence investors' choices. The current lack of transparency prevents comparability and is an impediment to the consistent use of ESG data by financial market participants. This in turn hampers ESG ratings' ability to provide investors with effective signals for an efficient capital allocation, which is key to enabling capital markets' contribution to the funding of the green transition. Against this background, the ECB welcomes that the proposed regulation requires ESG ratings providers to provide further clarity on the methodology for the ESG ratings they issue. That said, the ECB acknowledges that even with the benefit of the proposed regulation, different methodological approaches will continue to exist, and the dispersion of ESG rating scores will also continue. This reflects both the different methodologies across different providers, and partly also the fact that the aggregation of the various E, S and G components will continue to vary significantly. Thus, the ECB recommends that improvements to comparability should be monitored. If progress proves unsatisfactory, further legislative action may be considered.

2.3.3 Second, the risk of greenwashing in ESG ratings could erode consumer confidence in sustainable finance products, potentially causing sector-wide outflows, diminishing investment in sustainability, and delaying transition efforts, and could thereby contribute to a continued system-wide build-up of climate risks.

2.3.4 The ECB also welcomes that the proposed regulation requires ESG ratings providers to further clarify the purpose and objectives of the ESG ratings they issue[32]. Different approaches currently coexist in the market regarding the objectives and materiality approach underpinning ESG ratings. Some ESG ratings aim to quantify an entity's actual ESG performance (i.e. impact materiality) in order to inform various types of sustainability-oriented investment strategies. Numerous other ESG ratings, however, aim to measure the potential impact of ESG factors on the risk-return of the investment without a direct connection to the actual sustainability of the underlying real activities (i.e. financial materiality). The ECB considers that the coexistence of these different approaches, serving different investment strategies at the same time, contributes to confusion as to the purpose of ESG ratings, the degree to which they measure actual sustainability performance, and ultimately their ability to affect actual sustainability outcomes in the real economy. This can be a source of greenwashing, to

32 See recital 11 and Article 21 of the proposed regulation. In particular, Annex III(1), point (d), requires ESG ratings providers to disclose information to the public on the ratings' objective, clearly marking whether the rating is assessing risks, impacts or some other dimensions.

the extent that ESG ratings might not match public expectations about the real sustainability impact of the financed investments. At the same time, financial stability may also be negatively affected if ESG ratings are unduly used as direct measures for financial creditworthiness. Against this background, the ECB recommends that the proposed regulation envisages the imposition of an obligation on ESG ratings providers to communicate clearly, for instance through an explicit disclaimer, that ESG ratings, even those that are predominantly intended as risk metrics, are not direct metrics of credit risk. This would make it easier to distinguish ESG ratings from established market credit ratings, and thereby avoid any confusion as to their purpose.

2.3.5 Finally, while this goes beyond the scope of the proposed regulation, the ECB recommends that further and more concrete measures are also needed to ensure that credit rating agencies systematically and appropriately reflect climate change risks, as part of broader ESG considerations, in their methodologies and disclose the relevance and materiality of climate change risks in credit ratings. Credit rating agencies should make clear whether and how such ratings inform their assessment of the creditworthiness of a given entity, to ensure their appropriate use by the market as well as their comparability across different issuers.

2.4 *Relevance for the prudential supervision of credit institutions*

2.4.1 Significant institutions directly supervised by the ECB are expected to prudently manage and disclose climate-related and environmental risks[33]. In particular, they are expected to consider climate-related and environmental risks, as drivers of existing categories of risk, when formulating and implementing their business strategy and governance and risk management frameworks. In this context, the ECB has observed that some credit institutions, inter alia, use external ESG ratings to monitor climate-related risks[34].

2.4.2 The ECB considers that establishing comprehensive disclosure standards about the characteristics of ESG ratings, their methodologies and their data sources through the proposed regulation is critical in facilitating the use of ESG ratings as an input factor in the monitoring processes carried out by credit institutions. Credit institutions, as potential users of ESG ratings, need to be able to assess the objective of an ESG rating, the exact specification of topics covered by an ESG rating with regard to E, S, or G factors, and the respective contributions of individual factors to aggregate ratings. This is necessary to mitigate risks that may arise when credit institutions rely on aggregate ESG ratings, for example where a poor performance by a rated entity in terms of environmental factors might be masked by a good performance for social and governance factors. Transparency is key to ensuring that credit institutions do not mechanically apply ESG ratings as proxies of credit risk, but rather are able to extract from such ratings the relevant information for the purpose of their own risk assessment.

33 See ECB Banking Supervision, 'Guide on climate-related and environmental risks', November 2020, available on the ECB's website at www.ecb.europa.eu.

34 See ECB Banking Supervision, 'Walking the talk – Banks gearing up to manage risks from climate change and environmental degradation', November 2022, available on the ECB's website at www.ecb.europa.eu

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Where the ECB recommends that the proposed regulation is amended, specific drafting proposals are set out in a separate technical working document accompanied by an explanatory text to this effect. The technical working document is available in English on EUR-Lex.

Done at Frankfurt am Main, 4 October 2023.



The President of the ECB

Christine LAGARDE