Towards ESG 2.0

Making ESG ratings real sustainability ratings

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Summary

The increasing popularity of sustainable finance has given rise to a new dimension of business enterprise: ESG (Environmental, Social, Governance) data providers and raters, which play a crucial role in sustainable investing. Demand for ESG data is rapidly increasing, and is largely driven by both investors' demand and new regulations setting ESG disclosure requirements for companies in the EU and the US in particular.

At present, high ESG scores are mistakenly believed by professional and retail investors alike to be indicators of sustainability or *greenness*. Well-rated companies are supposed to value and enact practices that put environmental and climate protection, social justice and inclusivity, and transparency in governance at the core of their business model.

However, it has been well documented over the last years that ESG scores are far from portraying a valid picture of a company's green credentials. Instead of ensuring that the best performing companies get the recognition and financing they need, unregulated ESG ratings are misleading asset managers and investors. Ultimately, their flaws have exacerbated greenwashing on financial markets.

This is all the more visible in the transport sector, where large polluting companies with too slow decarbonisation pathways, for instance carmakers, aircraft manufacturers or shipping companies, obtain remarkably and disturbingly high ratings. A major problem is that ESG scores are heavily focused on the assessment of the financial impact of sustainability risks for the corporation (outside-in materiality), and don't take into account the impact the corporation has on nature and people which is relevant for wider financial stability risks and for policy objectives outside the field of finance.

In this context, it is essential to overhaul the current system of ESG ratings and regulate this growing market in Europe, starting from ensuring consistency between ratings and establishing regulatory frameworks for the usability and impact of ESG data.

The objectives of this position paper are both to address the inconsistency in ESG ratings and to propose recommendations to improve the European Commission's proposal *"on the transparency and integrity of Environmental, Social and Governance (ESG) rating activities"* published on 13th June 2023.

We recommend a more profound transformation of the current system of ESG ratings at EU level, making them true Sustainability Ratings, or "ESG 2.0". Thus, we call EU policy-makers to design a Regulation that:

1. **ensure ESG ratings follow a double materiality approach, therefore taking into consideration companies' exposure to ESG risks, but also and most importantly their ESG impacts on the outside world.**
2. **sets minimum sectoral quality thresholds for ESG ratings.**
3. **ensures that ESG ratings attribute more importance to absolute performance of companies in relation to their impact materiality, in addition to assessing companies' risk exposure compared with their peers.**
4. **ensure differentiated "E", "S", "G" ratings linking "E" to alignment with a 1.5°C pathway (=GHG emission reduction) and the phase-out of fossil fuels.**
5. **is coherent with existing legislation such as the Corporate Sustainability Reporting Directive, the Sustainable Finance Disclosure Regulation and the EU Taxonomy, so that data disclosed by companies and financial institutions is computed in meaningful ratings that can be used by investors and asset managers to channel their funds to most sustainable companies.**
6. **addresses the lack of transparency and comparability of ESG ratings and the governance of the ESG rating market (market concentration, conflicts of interests, etc).**
7. **enforces independent reviews and factual verification on the ground, promote stakeholders engagement and involvement, including from reputable Civil Society Organisations.**

With the newly proposed regulation on ESG rating activities, European policymakers have a significant opportunity to fix glaring problems with ESG ratings. Creating an appropriate regulatory regime for ESG ratings providers and data services is a chance to finally get ESG ratings to contribute to the objectives of the European Green Deal and the Paris Agreement, while setting gold standards at global level in order to attract and direct investments towards long-term decarbonisation goals.

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1. What are ESG ratings and why do they matter?

ESG ratings are defined as a comprehensive measure of a company's long-term commitments towards environmental, social and governance issues. ESG rating agencies (or providers) rate companies, issuers, securities or funds based on their ESG policies, systems and measures, using data they gather from multiple sources including ESG data providers, company's publication, media, NGOs or other stakeholders.

However, they are today mostly dedicated to measuring the companies' resilience to long-term environmental, social and governance risks - in other words, the impact of these ESG dimensions on the company itself, what we call inward materiality. As outlined below, the ESG impacts of the company - on nature, people and the planet - are much less taken into account.

Nonetheless, despite their problematic limitations, ESG ratings are still the main reference indicators in the sustainable finance sector to allocate capital. Industry data show that this is the fastest growing segment of the asset managers industry, overtaking most of the old investment strategies (exclusions, themed funds, Best in Class etc). While the growth in sustainable investing keeps accelerating, it is estimated by Bloomberg that one third of total assets under management, the world's financial wealth, is invested in sustainability's most popular proxy: ESG themed funds. Still, it is important to highlight that ESG themed funds do not currently provide any guarantee of sustainability. According to a more conservative evaluation of PwC[1], global asset managers are set to expand their ESG-related assets under management to $33.9 trillion by 2026, from $18.4 trillion in 2021. This will represent 21.5% of total global Assets Under Management.

Therefore, ESG investing is rapidly going from being a market niche to mainstream. This growth is unlikely to stop soon, as a factor driving the consumption of ESG data is the introduction of regulatory frameworks imposing comprehensive and granular reporting requirements for financial institutions and the products that they distribute, such as the Sustainable Finance Disclosure Regulation (SFDR), the UCITS and PRIIPs Regulations or the EU Taxonomy of sustainable investments. For instance, the SFDR imposes mandatory ESG disclosure obligations for asset managers.

De facto, third party ESG data providers and their ratings set the perspective of risks and opportunities and hold the potential to foster the capital inflow towards sustainable activities.

With their increase in popularity, ESG ratings are undergoing increased scrutiny and have recently been hit by a wave of criticism. In fact, firstly, they are - rightly so - accused of being a major cause of greenwashing in markets. We will see in Section 3 that this is also valid for the transport sector.

[1] PwC (2022), "Asset and Wealth management revolution 2022" (Link).

Secondly, ESG investing is facing a strong backlash in the USA where it is more and more fiercely opposed by Republicans. For instance, the Florida governor - and potential running candidate for the next US presidential election - Ron DeSantis signed a controversial anti-ESG bill that bans the state of Florida from issuing ESG or green bonds. The law also stops pension funds from considering ESG criteria when voting at companies' annual meetings[2]. Such backlash makes this agenda an increasingly politicised one, as ESG criteria are being associated with criticisms over so-called "Woke capitalism"[3]. In the European Union, this controversy is to date far less prominent than in the US.

The role played by ESG rating agencies is crucial despite the lack of binding framework for their operations. As we do not expect ESG ratings to go away anytime soon, we believe it is vital to deal with them, by using them and analysing them, to come up with a meaningful reform. As such, they cannot be ignored, and they should at least not be left to their current state.

2. State of play: the fallacy of ESG ratings

As previously highlighted, ESG ratings play a crucial role in sustainable investment and influence investors' strategic decisions. However, a literature review quickly reveals that they often fail on their purpose of being a reliable and comparable measure of sustainability performance and that they therefore lead to the wrong capital allocation. As pointed out by the European Securities and Markets Authority (ESMA), the ESG ratings market is "*unregulated and unsupervised*"[4].

Among several studies on the matter, in November 2020, the European Commission outsourced and published a *"Study on Sustainability-Related Ratings, Data and Research"*[5]. This study from the consultancy firm ERM, based both on desk research and stakeholders' engagement, gives an in-depth overview of the functioning and classification of ESG providers, data, methodologies and the use of sustainability-related products and services. Alongside the description of major players and methodologies, it also depicts the primary criticisms identified by stakeholders, representing an obstacle to a virtuous development of the market.

T&E took part in various stakeholder consultations, including a call for evidence organised by the Commission in 2022 on the matter, and expressed a clear view on the flaws and inconsistency of ESG ratings to evaluate sustainability performance of companies. The fact that companies in highly polluting industries - like carmakers - can obtain high environmental scores from some ESG rating agencies leads to investor confusion and highlights the need for greater transparency and the development of legal definitions.

[2] Financial Times (05.05.2023), Moral Money
[3] Corporate Governance Institute, "What is woke capitalism" (Link).
[4] ESMA (28.01.2021), Letter to the European Commission (Link).
[5] ERM (November 2020), Study on Sustainability-Related Ratings, Data and Research, (Link).

There are several factors that hinder the ESG ratings' transparency and reliability. Among others, we highlight in this section significant divergences when defining scope, measurement and weight, as well as several biases and the failure to adopt a double materiality approach in the assessment.

2.1. Double materiality: lack of focus on impact

Currently, the prevailing focus of ESG ratings is primarily limited to assessing the environmental, social, and governance risks associated with a company's business operations. In addition, ESG ratings classify companies' performance on a relative basis, with a peer-to-peer comparison of risk exposure within the same sector. An absolute[6] evaluation would be key to address the real performance of the company itself in relation to its external impacts.

This approach often results in greenwashing and the misallocation of capital. It is noteworthy that the majority of rating providers lack a comprehensive double materiality approach, which entails considering both the risks faced by the company and the impacts the company has on ESG factors. Regrettably, the absence of a correlation between ESG ratings and the tangible effects of companies on people and the environment has led to a distorted evaluation of companies' sustainability performance.

Furthermore, the double materiality principle serves as a fundamental rationale behind the cutting-edge and ambitious nature of current EU legislation on sustainable finance. In fact, the EU's regulatory framework is widely acknowledged as the most progressive and far-reaching on a global scale, precisely due to its commitment to addressing both the internal risks faced by companies and the external impacts they have on broader ESG considerations.

2.2. Divergences: same company, different ratings

In the context of ESG ratings, a divergence refers to a difference or disparity in the ratings assigned by various ESG rating agencies or providers to the same company.

The *"Aggregate Confusion: The Divergence of ESG Ratings"* paper[7], study of reference in the field, identifies three primary sources of divergence: scope, measurement, and weight, with the measurement being the most significant contributor at 56%. According to the study, *scope divergence* refers to the situation where ratings are based on different sets of attributes, *measurement divergence* indicates a situation where rating agencies measure the same attribute using different indicators and *weight divergence* emerges

[6] Absolute vs relative evaluation of performance - the relative approach focuses on comparative peer-to-peer analysis (i.e. the best-in-class within a given sector). The absolute approach allows an evaluation of the company's performance itself in relation to given science-based key performance indicators. From an impact materiality perspective the second one gives a more relevant indication of the actual sustainability performance of the company.

[7] Berg, Florian and Kölbel, Julian and Rigobon, Roberto (15.08.2019), "Aggregate Confusion: The Divergence of ESG Ratings", Available at SSRN (Link).

when rating agencies take different views on the importance of attributes. These divergences, as defined in the research, result in low agreement in ESG ratings provided by different vendors. Consequently causing uncertainty and challenges for investors in making informed decisions, thus reducing the effectiveness and relevance of ESG scores, both for investors and companies.

Among these divergences, the arbitrary allocation of value to the selected key performance indicators (KPIs) recurrently differs across ESG providers. In this regard, rating agencies may prioritise certain ESG dimensions over others based on their own assessment frameworks or stakeholder priorities. These subjective judgments can lead to inconsistencies in weightings and, subsequently, in overall ratings. Furthermore, every sector and industry results in a unique set of impacts, risks and opportunities and providers may adjust their weightings based on sector specific considerations. Even if this can be considered as a good practice, it rarely brings relevance to the right factors, as outlined in the section 3 below addressing major problems in ratings for the transport industry.

In addition, several transparency and discrepancy issues arise from the data sourcing to develop ESG rankings. In fact, its scarcity and difficult accessibility often induce the adoption of diverse estimation methodologies and the use of proxies from providers, thus heightening the already existing problems.

A detrimental consequence of divergences is that investors can search for a rating that fits their purpose and enable them to perpetuate business as usual, basically performing "ratings-shopping".

All the above outlined inconsistencies pose obstacles to effectively evaluating and comparing ESG performance across different sectors and entities. Therefore, it is essential for policy makers to recognise the need for a more cohesive and standardised approach. This entails strengthening data collection and analysis frameworks, as well as promoting the adoption of uniform methodologies, also entailing KPI weighting.

By actively addressing these concerns, policy makers can foster greater transparency, accuracy and comparability in assessing ESG performance, thereby facilitating informed decision-making and promoting sustainable practices.

2.3. Biases: unduly favouring large companies

There are three main types of biases that can lead to unreliable and inconsistent ESG ratings. As also outlined in the ERM study, they relate to the **size of the company, the geographical location of the company and their industry-based approach**.

The first one implies that larger companies often obtain higher ratings than SMEs, not necessarily because they perform better, but generally due to their capability to invest more resources in sustainability reporting.

The second one consists in awarding greater ratings to companies located in regions with higher mandatory reporting requirements, mostly due to the quality of the data available.

Finally, the industry bias, where the tendency of providers to determine KPIs at the sector level fails to account for the specificity of different companies. While the latter does point towards some measure of harmonisation, which is positive, it is still key to have some flexibility to account for different business models. Without considering the particularities of each and every business and therefore adapting the methodology, a risk arises of ending up with distorted ESG ratings.

2.4. Striking the right balance between top-down and bottom-up ESG strategies

A top-down strategy for ESG ratings involves taking a close look at macro-level elements, like sector-wide risks and opportunities, developments in a specific industrial sector (changes of leadership and market shares, etc) and regulatory changes impacting a sector. Third-party ESG providers investigate these larger factors when assessing material ESG matters for each industry. Therefore, they play a major role in the sustainability assessment of a company's performance.

On the other hand, a bottom-up strategy concentrates on the details, such as business-specific information, protocols, and procedures at company level. After detecting the ESG matters for each industry, third party ESG raters investigate individual businesses inside that sector, determining their performance and risk exposure by utilising company-specific data.

To date, most ESG rating agencies opt for either one or the other approach. Still, to mitigate the risk of discrepancies due to the rater's choice of approach, a methodology finding the right balance between top-down and bottom-up approaches would be more judicious. Coupled with a focus on impact materiality, the adoption of a hybrid approach holds the potential to significantly improve the quality of ESG ratings.

In a recent report *"Rate the Raters 2023, ESG ratings at a Crossroads"*[8] published by ERM, the authors highlight that *"Despite high usage, investors and corporates are also frustrated by the shortcomings of ESG ratings. Black box rating methodologies and questionable data accuracy are particular concerns. Our research indicates building tension. Most surveyed investors and companies have only modest confidence that ESG ratings accurately reflect sustainability performance, while a sizable minority of corporates feel they do not. Views on the overall usefulness and quality of ESG ratings are also slipping"*. This underlines that the major problems around ESG ratings are still present and need to be fixed. We believe that the new regulation proposed by the European Commission is the right instrument to drive that change.

[8] ERM (2023), "Rate the Raters 2023, ESG ratings at a crossroads" (Link).

The example of Sustainalytics is quite telling about the challenges faced by ESG rating agencies. It is widely considered as one of the leading ESG rating agencies in the world. It was acquired in 2020 by Morningstar Inc., a major US-based rating agency who is now its sole owner.

Sustainalytics claims to balance the objectivity and accuracy of ESG data and to follow a comprehensive and systematic approach. However, we have observed gaps and encountered limitations in its ratings and methodology. Three of these main methodological shortcomings are identified below:

1. Material ESG issues: Sustainalytics focuses mostly on financial materiality while leaving behind the impact materiality. Hence, it misses the double materiality perspective, which has now become a cornerstone in the EU Sustainable Finance agenda.

2. Industry-specific approach: Sustainalytics' methodology takes into account the unique ESG risks and opportunities within each industry. This industry-specific approach enables the rating provider to more accurately assess a company's performance in the context of its peers. Still, it makes it complicated to compare the impacts and risks of activity sectors between themselves. In practice, it means that the most sustainable company in a poorly performing industry may receive a high ESG rating, even if its overall sustainability could be very doubtful.

3. Forward looking metrics: Sustainalytics tries to provide forward-looking assessments that analyse a company's preparedness for ESG risks and potential future benefits. This method can provide a competitive advantage to large companies or financially stable companies while leaving behind small and mid-size companies. This shortcoming is still counter-balanced by the fact that forward-looking metrics, by helping consider risks and impacts over the mid- to long-term, are more likely than traditional short term credit ratings to take into account the risk of investing into stranded assets, for instance fossil fuel related assets in the transport and energy sectors.

3. ESG ratings in the transport sector: what is dysfunctional

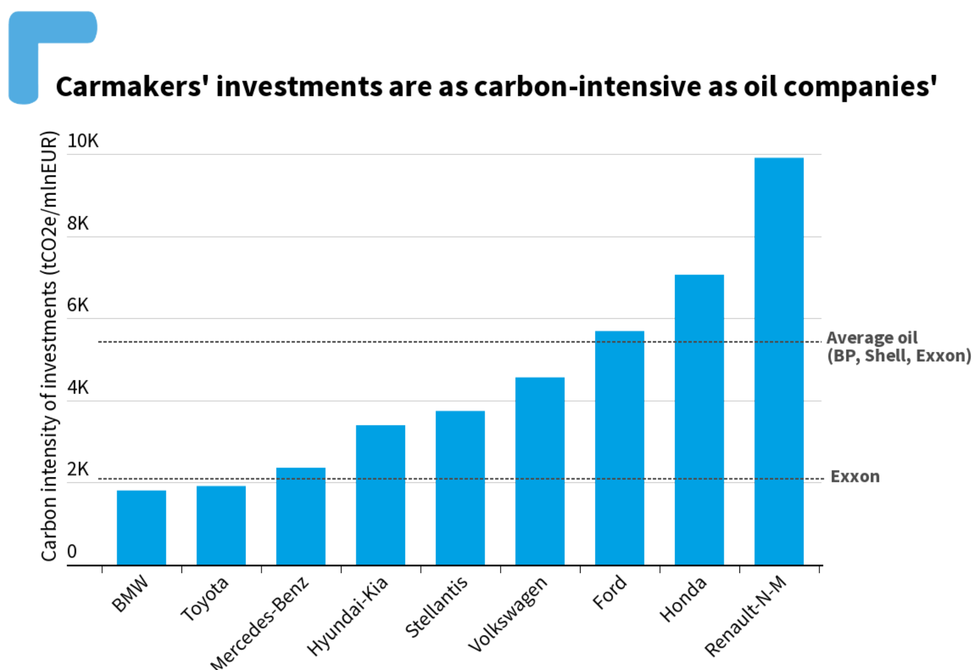
The transportation sector is a crucial European industry and a significant contributor to carbon emissions, accounting for 21% of global emissions. In the transport industry, ESG ratings are used to measure and assess the ESG performance of companies, funds dedicated to decarbonising the sector, and investment portfolios. However, rating inconsistencies currently hinder accurate performance evaluation and create confusion, discouraging investment in most sustainable activities or those accelerating their climate transition towards decarbonisation.

Additionally, the dispersion of ESG ratings can obstruct the market's ability to accurately price a firm's ESG performance. This can bear an impact on asset prices through investor preferences or fundamental value relevance (i.e., the ability of information disclosed by financial statements to capture and summarise the value of a company).

Not only do the current failings of ESG ratings negatively impact stakeholders who are seeking to make their activities and investments in the sector more sustainable, they are also the main enabler of greenwashing. This is highlighted in the case studies below.

3.1. The car industry - greener than green

As demonstrated in a report[9] published by T&E in September 2022, ESG ratings show no correlation and fail to capture the carmakers sector's true impact. **Despite CO2 emissions, together with air pollution, being possibly the most relevant of environmental KPIs for the sector, this specific parameter only represents, for example, 0.6% of the ESG rating for S&P and a similar % for MSCI.** Unsurprisingly, despite transport being Europe's largest CO2 emitter and our research showing that when lifecycle emissions are duly considered carmakers are actually "oil companies in disguise", car manufacturers



Source: Carmaker and oil major annual reports

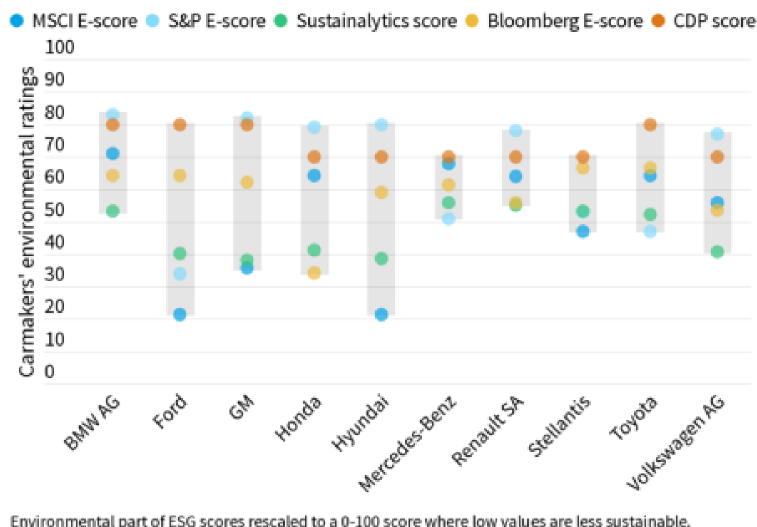
score very high with ESG raters on environmental grounds.

Despite Life Cycle emissions of a vehicle (the 'use of good sold' category, in particular) representing 98% of total emissions, in ESG ratings this key indicator only receives a <1% weight (e.g., only 0.6% in S&P's ESG assessments). Hence emissions, the most material and impactful factor in the industry, are largely irrelevant in ESG ratings.

[9] Transport & Environment (September 2022), Oil companies in disguise.

Below a graph extracted from the report highlights the dissenting distribution of E scores according to various ESG raters.

Figure 1.12: Distribution of E scores according to various ESG raters (2020)



Environmental part of ESG scores rescaled to a 0-100 score where low values are less sustainable.

What is striking is the discrepancy between medium to high ratings of OEMs and their environmental performances. For instance, Toyota is receiving rankings above 50/100 (when re-scaled to a 0-100 score where low values are less sustainable), while a recent study from the International Council on Clean Transportation shows that it is a laggard in the race to electrification and does not have a comprehensive strategy to switch its production from Internal Combustion Engines to Electric Vehicles[10].

The same discrepancies identified in the car manufacturing sector-related ratings can be found also in other transport sectors. Below an analysis of the shipping and aviation segments.

3.2. Shipping: on the same boat as cleantech companies

It is well recognised that the shipping industry significantly contributes to global GHG emissions and other environmentally harmful pollutants and is traditionally a little regulated sector. In 2020, the maritime sector accounted for about 2.8% of global GHG emissions[11].

One would therefore expect ESG ratings to measure the often poor sustainability performance of companies operating in this sector accordingly. However, the current ESG framework does not capture their true sustainability, similarly to the automotive industry.

[10] International Council on Clean Transportation (31.05.23), The Global Automaker Rating 2022 (Link).
[11] Faber, J. et al. (2021), Fourth IMO GHG Study 2020, International Maritime Organization (IMO).

In fact, while the ESG pillars' weighting may differ, the assessment of risks for the company is still given more importance than the impact the company has on people and the environment. For instance, MSCI clearly states that their *"ESG ratings assess how well companies manage risk compared with their peers, not across industries. Some investors will favor or avoid certain sectors for a variety of financially or values-driven reasons. Within a given industry, however, investors want to know how companies compare with one another based on their exposure to, and management of, financially relevant ESG risks."* [12]

We conducted an analysis of the publicly available ESG ratings of major container shipping companies operating in Europe, such as Hapag-lloyd, Maersk and Cosco, and it clearly emerged that:

- There is not enough information publicly available to conduct a meaningful comparative analysis between different companies' ratings;
- The attributed scores diverge across ESG rating providers;
- The weighting methodologies are not transparently defined for the sector;
- The majority of the performance assessment still focuses on the risk exposure of the different companies to ESG factors rather than on their ESG impact. This does not provide meaningful information about the actual sustainability of the companies considered.

Considering that the companies investigated are experiencing exponential growth, it would be of utmost importance for ESG ratings to reflect their actual E, S and G performance and the solidity of their decarbonisation and transition targets and plans. This would enable sustainable investors to take informed investment decisions, ultimately steering investments towards the best-in-class companies.

In addition, it is noteworthy that in 2022 - according to MSCI ESG Ratings and Climate Search Tool, CDP scores on climate change and Sustainalytics company's ESG Risk Ratings - the giant Danish shipping company Maersk was rated very similarly to cleantech companies such as Vestas Wind systems or SSE Renewables. From an environmental impact perspective, cleantech companies focus on developing and providing environmentally friendly solutions or technologies that have a positive impact on the environment. They often aim to reduce carbon emissions, promote renewable energy, or improve resource efficiency. In contrast, container shipping companies primarily focus on transporting goods across the globe, which inherently involves significant carbon emissions and environmental impact. In this context, the similar ESG ratings attributed to the companies operating in two different sectors might therefore be misleading for investors.

A meaningful ESG reform at European level should define minimum environmental thresholds for key economic sectors. For a very specific sector like shipping and the maritime industry, we recommend to attribute high scores to the most material environmental KPIs, these being:

[12] Data retrieved from MSCI website on 09/06/23.

1. Climate change mitigation and in particular **GHG emissions in all their scopes** (Scopes 1, 2, 3) relevant for all companies active in the shipping sector and, targeting in particular:
    - For operators the fuel used on board the ship and considering a Well-to-Wake approach (at least 30% of E pillar);
    - For manufacturers the emissions linked to the construction of the ship (at least 30% of E pillar);
    - For shipping companies responsible for the ship, the emissions related to the decommissioning of the ship (at least 30% of E pillar).
2. **Air pollution**, including emissions of SOx, NOx and particulate matter (at least 20% of E pillar).
3. Age of the ships and replacement ratio.
4. Information about sustainable fuels used on board, including their origin and type.
5. Waste management, mostly for manufacturing purposes (the ships need to have specific systems on board).

We also recommend enhancing the providers' assessment of the absolute performance of companies. In fact, the evidence of companies' disclosure on the relevant topics is not enough to appropriately assess the attainment of targets in line with their decarbonisation pathway.

3.3. Aviation

We assessed the ESG evaluation of sustainability performance across aircraft manufacturers like Airbus SE, ThyssenKrupp AG and Safran SA. From our research we draw similar conclusions than in other transport sectors on systemic issues encountered.

	MSCI	CDP	Sustainalytics
Airbus	BBB	A-	Medium Risk
Safran	A	A-	Medium Risk
Thyssenkrupp	N/A	A	High Risk
Dassault Aviation	B	F	High Risk

Source: MSCI, CDP and Sustainalytics publicly available data, 2022

Overall, with reference to the climate change topic, all companies considered seem to be exposed from medium to high risk according to Sustainalytics and most of them score quite high according to CDP and MSCI ratings.

However, does this provide stakeholders with the information they need to allocate money on sustainability leaders rather than laggards? We believe that investors should be able to understand the

sustainability of the sector as a whole, including its absolute impact, as well as the absolute and relative performance of individual companies within the industry.

To assess the climate and environmental credentials of companies active in the aviation sector we advise to take into account the following indicators as most relevant:
For aircraft manufacturers:

1. Climate change mitigation and in particular **Scope 3 GHG emissions**;
2. Use of resources and percentage of circularity;
3. Percentage of zero emissions technologies.

For airlines:

1. Climate change mitigation and in particular **Scope 3 GHG emissions, including non-CO2 emissions;**
2. Information about Sustainable Aviation Fuels used, including their origin and type;
3. Age of the fleet and replacement ratio;

In conclusion, regulators must address discrepancies in ESG ratings and ensure that sustainable finance practices in the transport industry are accurately evaluated. In order to achieve meaningful scoring results, we reiterate the importance of carrying out, in addition to peer-to-peer analysis, absolute performance assessments of both overall sectors and individual companies. It would be for example more substantial to evaluate companies' performance in relation to emissions with reference to commonly established decarbonisation targets at EU level.
By doing so, they will promote transparency, foster more sustainable capital allocation, and effectively contribute to global environmental and social goals.

4. Towards Sustainability Ratings and ESG 2.0

The ESG ratings' system needs to be re-designed and binding legislation will play an accelerating role in this regard. The lack of a timely intervention is likely to nullify most of the EU's efforts to steer capital flows towards sustainable economic activities and thus to reach the objectives set by the EU Green Deal. Without a reform towards ESG 2.0, users of ESG data and ratings should adopt a cautious approach and limit their reliance on ESG ratings.

4.1 Policy recommendations:

The new legislation on ESG rating activities at EU level should be enhanced with a set of binding criteria and principles for ESG rating companies, in addition to putting in place a stronger governance for this growing market. Robust and reliable assessments of ESG performance could prevent the risk of corporate greenwashing. Our key recommendations to policy-makers are the following:

1. To be considered as a real evaluation of sustainability performance, **ESG ratings shall follow the double materiality principle**, thus taking into account both companies' inward risks and outside impacts. A legally binding definition of ESG ratings at EU level should enshrine this principle into the new Regulation.
2. **The EU should focus on setting minimum sectoral quality thresholds for ESG ratings**. The KPIs included in ESG ratings should be relevant, meaningful and aligned with the key sustainability challenges faced by corporates. Metrics should be chosen based on their materiality, impact and ability to provide insights into sustainability practices and risks.
   One option is to establish a minimum percentage of impact indicators (e.g. 50%) and to attribute minimum weight to material factors in high impact sectors. For example: for car manufacturers, a minimum weight should be assigned to the very material issue of vehicle life-cycle emissions (e.g. 60% instead of 0,6%).
   The "E" in ESG ratings should be clearly linked to alignment with a 1.5°C pathway and the gradual reduction of GHG emissions. The phase-out of high impact activities like operations in the fossil fuels sector should be a prominent indicator, while building on the Do No Significant Harm principle enshrined in the EU Taxonomy Regulation to identify activities at odds with climate objectives.
   Full correlation between ESG ratings should not be an objective in itself. Still, it is necessary to make sure that crucial materials issues (like Scope 3 emissions for transport industry) are awarded a much higher weight than anecdotal criteria on the use of office furniture by a firm's employee for instance.
3. **The EU should ensure that ESG ratings attribute greater importance to absolute performance of companies in relation to their impact materiality,** in addition to assessing how well companies manage risk compared with their peers in their sectors of operations. To have a comprehensive overview on companies' performance, investors shall access information that assesses both the absolute performance of the company and the sector, and the relative performance of the company in relation to its peers.
4. **The ESG proposal shall take into account and be coherent with existing legislation such as the EU Taxonomy Regulation, the Corporate Sustainability Reporting Directive (CSRD) and future European Sustainability Reporting Standards (ESRS).**
   The CSRD and its sector-specific standards will help address the problems of lack of standardised ESG data reported by companies and allow for better comparison of companies within the same industry. The KPIs identified in the ESRS should form the basis of the criteria that ESG rating agencies use in their rating methodologies.
   A bridge should also be created between the Taxonomy scores and ESG scores. ESG rating agencies could disclose, for example, what percentage of the E score is based on factors deemed material in the Taxonomy. A similar score could be disclosed for the use of the S and G indicators extracted from the CSRD-related KPIs, as the Taxonomy Regulation will not provide a framework for S and G indicators in the coming years. This bridge could alleviate the risk that the entire architecture of EU's sustainability disclosures becomes a tick boxing exercise whilst markets keep using poor ESG ratings.

5. **The new EU Regulation shall provide a set of governance reforms including:**
    - ❖ Improving transparency on the methodology used by the providers, including on data sources and verification methods for company's data;
    - ❖ Requiring issuers of ESG ratings and assessments in Europe to be registered and supervised by a public authority. ESMA is the best placed institution to act as a supervisor, because it is already in charge of credit rating agencies (CRAs) at EU level, and integrated in its work plan the gradual inclusion of ESG factors in credit ratings. For environmental indicators, ESMA should cooperate with other agencies such as the European Environment Agency.
    - ❖ Setting up controls by supervision authorities at EU level in order to hold ratings agencies accountable (via sanctions on abusive practices for instance)
    - ❖ Reducing risks of conflicts of interests that may arise in the business models of ESG providers
    - ❖ Put an end to the reliance on data provided, and even corrected, by the assessed entity. Instead, require independent reviews and factual verification on the ground, promote stakeholders engagement and involvement, including from reputable Civil Society Organisations.
    - ❖ Addressing the structure of the market: concentration of a market that is currently undergoing a process of consolidation by a handful of operators - mostly large, oligopolistic US firms whose primary business is credit rating.

In conclusion, the EU needs to 'connect the dots' and complete its sustainability disclosure architecture with clear guidelines to translate all of the above-mentioned data into basic, transparent and reliable sustainability scores. This is what ESG ratings were meant to be and are currently mistaken for.

The growth in demand for ESG products needs to be matched with sound regulatory requirements, so that their reliability and quality can significantly improve.

Sustainability Ratings are currently the missing piece in the sustainable finance puzzle at EU level. The EU has made progress, despite severe setbacks and greenwashing attempts, in progressing towards a better definition of what "sustainability" means and in getting corporates and financial institutions to disclose granular information about their ESG risks and impacts. Setting up sound and coherent mandatory requirements for ESG ratings would complement these past efforts, while providing a much-needed operational tool for investors. We now need ESG 2.0 in Europe, more than ever.

Further information

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