Norges Bank
Investment
Management

European Commission
DG FISMA
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Feedback to the European Commission on the proposed Regulation on ESG ratings

We refer to the feedback period on the European Commission's legislative proposal for a Regulation on the transparency and integrity of Environmental, Social and Governance (ESG) rating activities, adopted on 13 June 2023. We appreciate the opportunity to provide our perspective on this legislative proposal.

Norges Bank Investment Management is the investment management division of the Norwegian Central Bank (Norges Bank) and is responsible for investing the Norwegian Government Pension Fund Global. NBIM is a globally diversified investment manager with 12,429 billion Norwegian kroner, or around 1,186 billion EUR, at year end 2022. Of this total, ca 148 billion EUR was invested in the shares of 1,171 companies in 22 EU countries at year end.

As a long-term and global investor, we consider our return to be dependent on sustainable development in economic, environmental and social terms. We therefore need information on companies' exposure to sustainability risks and opportunities, how these are managed, and relevant performance metrics. Our analysis of ESG risk in our portfolio draws more heavily on internal analysis of the metrics and indicators underlying ESG ratings rather than the ratings themselves. However, while we do not use individual ESG ratings directly to make investment decisions, we do consider them a useful complimentary source of information for our risk management and stewardship activities.

We concur with the European Commission's assessment that the ESG rating market suffers from deficiencies which could undermine investors' and rated entities' confidence in ratings. We welcome the Commission's intention to improve the transparency on the characteristics of ESG ratings, their methodologies and data sources. Increased transparency on ESG ratings can enhance pricing efficiency and the well-functioning of markets. This can contribute to a higher degree of confidence in the use of these products within financial markets, benefiting investors while also enhancing market integrity, risk pricing, and capital allocation.

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The low correlation between ESG ratings issued by different ratings providers is not surprising, given the diversity in assumptions, objectives and methodological approaches that they employ. For instance, some ESG ratings aim to assess entities' exposure to financial risks tied to ESG issues (financial materiality), while others aim to assess whether companies' commitments and practices are aligned with societal goals, or their impact on the environment and society (impact materiality). Similarly, some ESG ratings assess a company relative to rated entities in the same industry, while others compare it to all rated entities across industries. This diversity is also reflected in the wide range of ratings' use cases across the investment industry, ranging from financial decision-making to impact measurement and reporting. This variety in ESG ratings can be positive if well understood, hence we agree with the Commission's intention not to try and standardise ESG ratings outputs. However, the approach taken by providers might not always be apparent to stakeholders, which can cause ESG ratings to be misinterpreted and misapplied. We therefore welcome the proposed requirements for ESG rating providers to disclose information on the methodologies, models and key rating assumptions used in their rating products, including the approach taken to materiality. In particular, we support disclosure requirements in Annex III, article 1, including overview of rating methodologies, rating objective, and information on whether the rating is expressed in absolute or relative values. Regarding additional disclosures to users and undertakings as per Annex III, article 2, we suggest an additional requirement to disclose the definition of a rated entity's peer group if the rating is expressed in relative terms.

Specific methodologies can also differ considerably in the scope of issues assessed, the choice of data points and indicators, and the weighing factors, as well as the data sources used and the use of estimation. Reliability can also be an issue, given the currently infrequent assurance of sustainability reporting. We believe that rating providers should publicly disclose their methodologies, data sources, and the weights used to generate overall ESG ratings. They should also be transparent on substantive changes they make to their methodology, and explain the impact these have on the quality, coverage, and distribution of ESG ratings. We therefore welcome the proposed disclosure in Annex III, article 1, on data processes (including data sources, estimation of input data, and frequency of data updates), and on the weighing of both the overarching ESG factors categories and individual E, S and G factors.

Regarding changes to rating methodologies, we believe that transparency on the methodology update policy (e.g. whether ad-hoc or conducted with a set frequency) and approach to historical ratings (whether these are re-run with updated methodologies) could be more suitable than an obligation to review methodologies at least annually. A mandatory annual update might not be the appropriate frequency for every rating approach, and could potentially lead to decreased comparability of ratings. We suggest instead that the disclosure requirement on changes to the rating methodology is enhanced to enable users to understand the impact that methodology changes can have. We also support the overarching obligation for ESG rating providers to ensure that the information used is of sufficient quality and from reliable sources, included in Article 14. We believe that ratings providers should

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strive to use externally assured data whenever available, and information on the percentage of assured data among data inputs could be disclosed to encourage this practice.

We believe that ESG rating providers should have appropriate systems and controls in place to detect and correct efforts, and adequate resources to ensure ratings quality. They should also disclose the use of artificial intelligence in data estimation, quality assurance, and analysis. We therefore support the overarching obligation to employ adequate resources and to disclose information on the use of artificial intelligence. ESG rating providers often use questionnaires to gather data from rated entities, but do not always engage with them to correct errors or supplement data points. While acknowledging that engagement with rating providers can be resource-intensive from an issuer's perspective, we believe that ESG rating providers should provide rated entities with an opportunity to correct any factual mistake, a so-called "right to reply". This requirement could potentially be built into proposed article 18 on complaints-handling mechanisms, which is currently not specific to rated entities, by adding a reserved policy for assessing feedback from issuers.

We also concur with the European Commission's intention to improve the transparency of operations on ESG rating providers. Commercial providers may have a conflict of interest in cases when they have a business relationship with companies to which they assign ratings. Governance and funding models of rating providers can also be opaque, thereby hindering users' assessment of potential conflicts of interest linked to their ownership structure. We believe that ESG rating providers should have policies and procedures in place to manage conflicts of interest, including functional separation of business units assigning ESG ratings and providing advisory services to rated entities. We therefore support requirements on independence and avoidance of conflicts of interest in Article 23, however suggest that disclosure of conflicts of interest should not be made only to ESMA but also to users of ESG ratings (i.e., added to Annex III, Article 2). We note the possibility that the European Securities and Markets Authority may require companies to take measures to mitigate conflicts of interests, including the establishment of "an independent oversight function" representing stakeholders, including users of the ratings and contributors to such ratings. We would encourage the Commission to clarify what is meant by "contributors to [ESG] ratings" and note that this process of independent oversight should be designed in ways that prevent it from becoming overly burdensome.

Regarding Annex III, Article 1 on disclosure to the public, we note the requirement for ESG ratings providers to provide information on "whether and how the methodologies are based on scientific evidence". While there might be scientific evidence available on the relevance of specific ESG risk factors to an entity's financial performance, which would be relevant in the construction of an ESG rating adopting a financial materiality approach, this provision may be inconsistent with Article 14(11), which requires providers to explicitly mention that their ESG ratings are opinions. It might be helpful to clarify this reference by requiring providers to disclose the peer-reviewed research they have used to develop their specific methodologies and approaches, if any. Regarding Annex III, Article 2, we would like to seek clarification on the intention behind the requirement to disclose which metrics have been selected as

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relevant, as part of the more granular overview of methodologies to be provided to users and rated entities. Information on relevance of the various ESG metrics or indicators employed could be inferred through the required disclosure of the weighting methodology and individual weights for E, S and G factors. If the intention is however to enhance transparency on which metrics are being used for a single E, S or G factor, then the text could benefit from clarification.

Finally, the market for ESG ratings is global and many providers operate across borders. We welcome the work on ESG ratings and data products providers undertaken by the International Organisation of Securities Commissions (IOSCO) and its recommendations from November 2021, and support the global harmonisation of regulatory regimes for ESG rating providers. We therefore support the decision by the European Commission to align the definition of ESG ratings with the one provided by IOSCO, and importantly the role played by the third country's compliance with the IOSCO recommendations in the Commission's equivalence and endorsement framework for third country ESG rating providers.

We thank you for considering our perspective and remain at your disposal should you wish to discuss these matters further.

Yours sincerely

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