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Common – Current situation of trends of the European investors for ESG (Environment, Social, Governance) companies: Improving the reliability and transparency of ESG ratings activities towards decarbonisation

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【概要：Summary】
ESG (Environment, Social, Governance) is an important concept to assess sustainability issues, social responsibility, and good governance of companies. Also in the EU, ESG is becoming an important concept as ESG ratings play an increasingly important role to assess companies' sustainability in the financial market, as a part of the investors' sustainable investment strategies. The ESG ratings and classification of market actors enable the investors to direct investments into companies that are putting their priorities in the decarbonisation of their products and services and that are directing their efforts towards the achievement of the European Green Deal's net-zero GHG emissions target. Thereby, ESG ranking is a tool that can be used to effectively facilitate the transition towards decarbonizing the EU's economy. However, there are challenges within the ESG rating, regarding data quality, and there are concerns regarding a lack of transparency and regulation, which can lead to "greenwashing" of companies, since also major polluting companies are getting high ESG scores despite their poor environmental record. Therefore, the European Commission presented a proposal on a Regulation to improve the reliability and transparency of ESG ratings activities (COM (2023) 314 final). Furthermore, new regulations like Sustainable Finance Disclosure Regulation (SFDR), Corporate Sustainability Reporting Directive (CSRD), Corporate Sustainability Due Diligence Directive (CSDDD), Carbon Border Adjustment Mechanism (CBAM), and the EU Taxonomy regulations are introduced to setting new standards for evaluating transparency, accountability, and environmental performance of companies. The new rules are expected to make ESG ratings and their underlying methodologies more transparent towards achieving higher sustainability and decarbonization of companies.

【記事：Article】

1. The concept of ESG and the EU's ESG reporting standards and legislation

The concept of Environmental, social and governance (ESG) is a set of standards assessing a company's performance regarding environmental criteria (E), social criteria (S) and governance criteria (G) (Bernoville 2024). The ESG's environmental criteria (E) examine how a company

performs regarding its environmental impacts. The social criteria (S) examine how a company manages relationships with employees, suppliers, customers, among others, while governance (G) defines a set of rules, best practices, and processes that determine how an organisation is managed and controlled (Conmy n.d., Robeco n.d.a). Since decarbonization has become an important topic in the ESG concept, many organizations and companies try to define net-zero strategies, which are measure in ESG criteria and then analysed by conscious investors to deciding on potential investments in those companies (Bernoville 2024, UNDP 2023).

In the EU, several ESG reporting regulations and frameworks have been introduced or are in preparation, setting new standards for transparency, accountability, and environmental performance (Bernoville 2024, Robeco n.d.b).

The EU's ESG related legislation includes, most importantly, the Sustainable Finance Disclosure Regulation (SFDR) (Regulation (EU) 2019/2088), the Corporate Sustainability Reporting Directive (CSRD), the Corporate Sustainability Due Diligence Directive (CSDDD), and the EU Taxonomy (Bernoville 2024).

The CSRD (Directive (EU) 2022/2464) covers larger EU and non-EU companies that must produce a sustainability report covering a range of ESG topics including climate change (Bell et.al. 2023, European Commission n.d.a). The CSRD Directive helps investors and other stakeholders to evaluate the sustainability performance of companies (Directive (EU) 2022/2464). Furthermore, the Corporate Sustainability Due Diligence Directive (CSDDD) will soon be introduced, obliging companies to identify, prevent, mitigate, and account for adverse sustainability impacts in their operations and value chains to make their business model compatible with the global warming limit of 1.5°C under the Paris Agreement (Bernoville 2024, Council of the EU 2024a, European Parliament 2024). Meanwhile, the European Financial Reporting Advisory Group (EFRAG) and the International Sustainability Standards Board (ISSB) have published guidance on their interoperability for climate reporting to give companies the opportunity to comply with both standards regarding climate reporting (DG for Financial Stability 2024, ESRS/ISSB n.d., European Commission 2023c).

The new EU Taxonomy regulation (Regulation (EU) 2020/852) aims to guide investment toward sustainable projects aligned with a net-zero trajectory towards 2050 (Bernoville 2024, Robeco n.d.b). Six key climate and environmental objectives are defined to assesses the environmental sustainability of economic activities (European Commission n.d.b, n.d.c). The EU Taxonomy is expected to help companies to redirect their investment into low or zero CO_2 emission solutions, while protecting private investors from companies' greenwashing (European Commission 2023b). Early reporting trends show that companies are increasingly using the EU Taxonomy as part of their transition efforts (European Commission 2023a).

2. The EU's ESG rating providers - activities, shortcomings and necessary improvements

ESG ratings play an increasingly important role in the EU sustainable finance market and provide information about the sustainability performance of a company or a financial instrument, regarding the exposure to sustainability risks and/or its impact on people and the environment (European Commission n.d.d). Investors and benchmark administrators use ESG ratings as part of their sustainable investment strategies (European Commission 2023a, DG for Financial Stability 2023). ESG ratings can attract investment for decarbonization, as ESG rankings can improve the companies' environmental reputation, and a company's improvement in its ESG ranking could

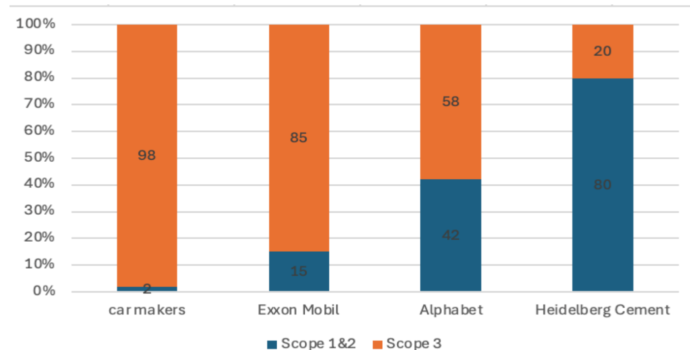
attract new investment as the corporate environmental reputation is improving (European Commission 2023a). At the same time, ESG ratings can also promote transparency regarding a company's efforts towards increasing its sustainability by fostering more sustainable investments and consequently, they can reduce greenwashing.

However, the ESG ratings market currently suffers from a lack of transparency. It is widely unregulated, and here the greenwashing can start as a major problem as polluters are getting high ESG scores despite their poor environmental record. One example is the case of automobile manufacturing companies, which are major CO_2 emitters mainly due to their scope 3 emissions. Nevertheless, they score high on environmental criteria, based on major ESG raters' assessments (Ranzato 2023). Therefore, to generally improve transparency of ESG ratings and the integrity of operations of ESG rating providers, the European Commission is proposing a Regulation on the transparency and integrity of ESG rating activities (COM (2023) 314 final). The objectives are to enhancing the quality of ESG ratings by (i) improving transparency of ESG ratings characteristics and methodologies, by (ii) ensuring increased integrity of operations of ESG rating providers and preventing the risks of conflict of interest at ESG rating providers' level, while still allowing the ESG rating providers to maintain full control over their methodologies (COM (2023) 314 final, DG for Financial Stability 2023, European Commission 2023a). To ensure the quality and reliability of ESG ratings, protecting investors and maintaining market integrity, ESG rating providers will be authorized and supervised by the European Securities and Markets Authority (ESMA) (Council of the EU 2024b).

3. The problem of ESG ratings towards decarbonisation: The example of car makers' scope 3 emissions

ESG ratings, when functioning, can play a major role for the investor's decision in favour of investments in companies with sustainable production and towards decarbonisation of industries (Cuatrecasas 2024, Ranzato 2023). However, the current ESG ratings lack of transparency in the applied methodologies and they are lacking clarity on what the rating intends to represent. Assessments often occur through a peer-to-peer comparison, disregarding the companies' absolute performance regarding CO_2 emission reduction, making companies scoring high if their environmental results are slightly better than those of their competitors (Ranzato 2023). A study conducted by the environmental NGO Transport & Environment (T&E) (T&E 2022a, 2022b) assessed the automobile manufacturers' ESG rating regarding their scope 3 emissions, based on S&P 2020 figures (T&E 2022b).

Fig 1: Share of GHG emissions by scope, in %



(Source: S&P FY 2020, cited by T&E 2022b)

While the average scope 3 emissions accounts for 98% of a carmakers life cycle emissions, for Alphabet (Google) they are 58%, 85% for Exxon Mobil and 20% for Heidelberg Cement (T&E 2022b). Regarding the carmakers GHG emissions, the vast majority (98%) are scope 3 emissions, primarily emitted due to the use of cars, including the total distance travelled and fuel consumption of cars (T&E 2022a). This means that in case of

automobile manufacturers, about 98% of the total emissions are only captured when scope 3 emissions are included (T&E 2022b). However, carmakers use selective data for their scope 3 emission calculations, like basing their vehicles' lifetime average emissions on a rather low 100,000 kilometres total distance and thereby they lower their total scope 3 emissions (T&E 2022a). Due to this approach of selected scope 3 emissions and their very limited weight in ESG calculations, with scope 3 emissions only accounting for 0.6% of the total ESG-Score, car manufacturers receive a higher ESG rating than their high scope 3 emissions would suggest (T&E 2022b). Consequently, the car industry's ESG ratings fail to capture the companies' true climate impact and lack of decarbonisation (T&E 2022a, 2022b). As ESG ratings influence and drive private investments, these flaws in the ESG rating, caused by significantly underreporting of scope 3 emissions, mislead investors who then put their capital into the wrong companies that in absolute might not take enough efforts to decarbonise (Ranzato 2023). Therefore, to accelerate the green transition and decarbonization, ESG indexes would need to put more weight on the car companies' life-cycle emissions and address the substantial under-representation of scope 3 emissions. In this context, the EU's new Regulation on the transparency and integrity of ESG rating activities (COM (2023) 314 final) could improve the reliability of ESG ratings activities.

Meanwhile, since the EU Taxonomy is incorporated into the SFDR's disclosure requirements for financial market participants and included in the CSRD legislation to guide companies in reporting on their sustainability performance, investors should use the EU taxonomy as an E score, as it better represents the environmental performance of companies (T&E 2022b). Together, the CSRD, the SFDR and the EU Taxonomy are expected to help financial market participants to address environmental and governance issues and the legislation could help investors make better informed decisions towards creating a sustainable financial system that supports the EU's goal of becoming climate-neutral by 2050 (Key ESG 2024, DG for Financial Stability 2023, European Commission n.d.d). The new Regulation on the transparency and integrity of ESG rating activities (COM (2023) 314 final) is expected to strengthen the reliability and comparability of ESG ratings and to improve the integrity of the operations of ESG ratings providers (Council of the EU 2024b). Finally, decarbonization and sustainability measures could further be supported by separating the ratings of E, S and G factors to emphasise the environment related activities of companies (Cuatrecasas 2024).

4. Conclusion and considerations

ESG ratings play an important and enabling role for the proper functioning of the EU's sustainable finance market, as they provide important information on how a company performs regarding the EU's sustainability and decarbonisation targets. Since decarbonisation plays an important role to achieve the 2050 net zero emission target, companies that effectively reduce their carbon footprint should better benefit from high ESG ratings.

Therefore, as the example of the carmakers and their underreporting of scope 3 emissions for a car's lifetime shows, the ESG ratings' flaws need to be tackled to end the misleading high ESG ratings for companies that in absolute might not take enough efforts to decarbonise, and thereby mislead investors to put their capital into the wrong direction and companies.

It needs to be constantly ensured that ESG ratings of companies will not become a tool for greenwashing. Therefore, new rules on ESG ranking providers need to ensure the high quality and reliability of ESG ratings and services in the EU and at global level.

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