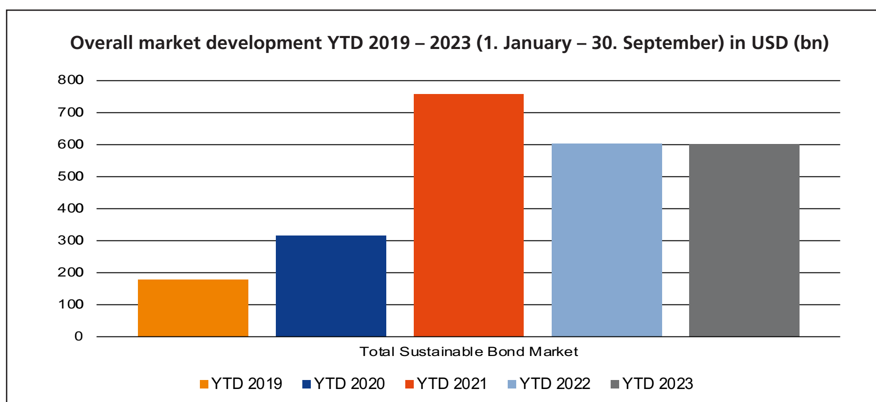
Sustainable Bond Market: Autumn forecast

Market development is more qualitatively than quantitatively driven.

After three quarters of the year, our 2023 thesis of more qualitatively than quantitatively driven developments in the Sustainable Bond market is fully confirmed.



Source: DZ BANK

Although the bond market performed well in the first half of the year, investors remain concerned about the uncertain macroeconomic outlook and ongoing geopolitical risks. This is also affecting the Sustainable Bond market, which traded weaker in the third quarter than in the previous two quarters. After nine months, new issuance volume was slightly below the comparable volume of the previous year at around $598.8 billion (9m/2022: $603.7 billion).

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Dear Reader,

We are pleased to present the latest edition of our DZ BANK Sustainable Finance Bulletin.

Due to a continued uncertain macroeconomic outlook and ongoing geopolitical risks, the Sustainable Bond market was weaker in Q3 than in the previous two quarters. Our revised autumn forecast assumes a marginal increase in the new issuance volume of around 3%. Over the next 12 to 18 months, we expect a gradual return to growth in all segments. ICMA's recent updates to the Climate Transition Finance Handbook and the Sustainability-Linked Bond Principles will support this growth through transparency and best practice. A credible plan outlining the steps to shift the business model to a 1.5-degree future is the be-all and end-all of transformation anyway. Read more about this in our Climate Bonds Initiative guest contribution on „Identifying agricultural transformation plans". Finally, we look at the fast-growing market for ESG ratings, for whose providers the EU Commission recently presented a regulatory proposal.

Enjoy reading! Stay healthy!

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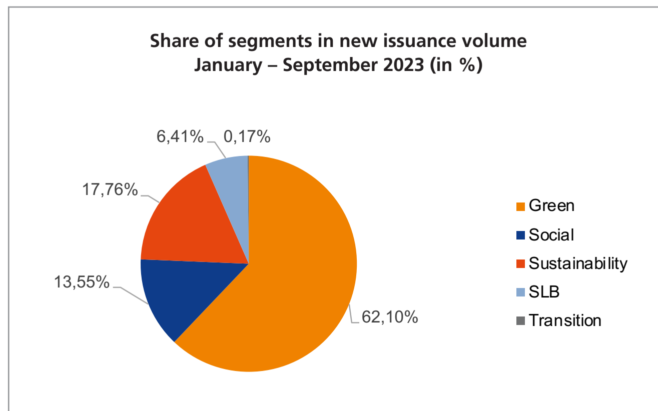
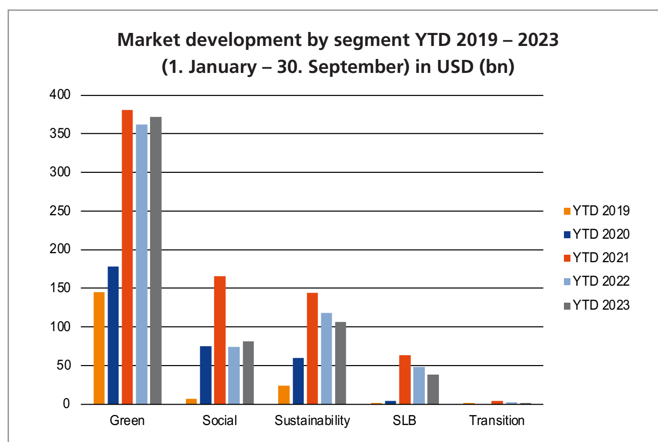
In the individual segments of the Sustainable Bond market, the picture after three quarters is quite mixed.

New issuance volumes of Green Bonds ($371.8 billion) and Social Bonds ($81.1 billion) were 3% and 10% higher, respectively, versus comparable volumes of the previous year. With a 62% share of new issuance volume, the Green Bond segment thus once again proved to be a solid anchor in the overall market, even if it can currently be assumed that the most established segment – contrary to the forecasts from the first and second quarters – is unlikely to set a new record in 2023. One bright spot is FIG Green Bonds, whose new issuance volume after nine months was around 55% higher than in the comparable period of the previous year.



Source: DZ BANK

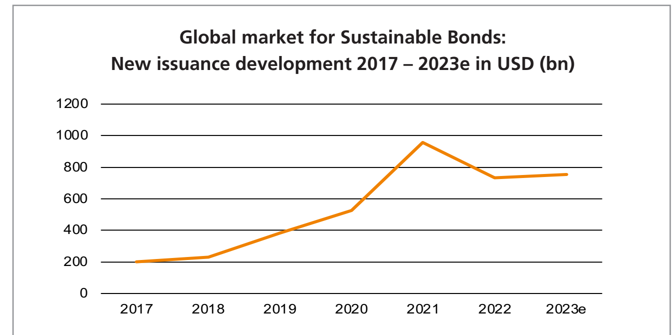
Sustainability Bonds (-10% yoy), Target-linked Bonds (-22% yoy) and Transition Bonds (-57% yoy), on the other hand, are much more vulnerable to the still volatile market environment. In the case of Target-linked structures, many investors remain sceptical about the materiality of the selected key performance indicators and the level of ambition of the underlying sustainability targets. Although the order books for Target-linked Bonds, which were so popular in 2021, continue to be well filled, they have not yet regained their former strength in terms of volume.



Source: DZ BANK

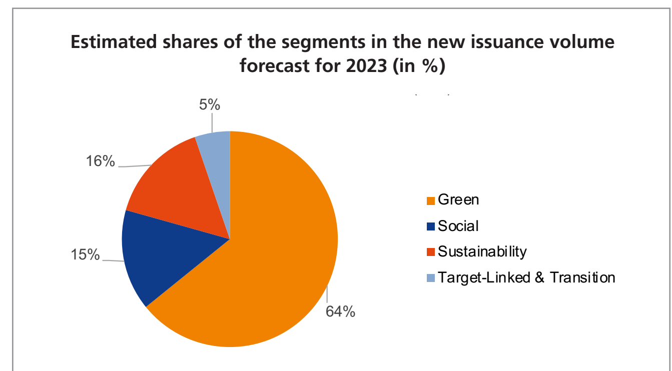
No new highs for the time being.

As we already laid out at the beginning of the year, new issuance volumes of Sustainable Bonds will not go through the roof in 2023. Our revised autumn forecast currently assumes a marginal increase in new issuance volume of around 3% to $755 billion for the overall market (2022: $734 billion).



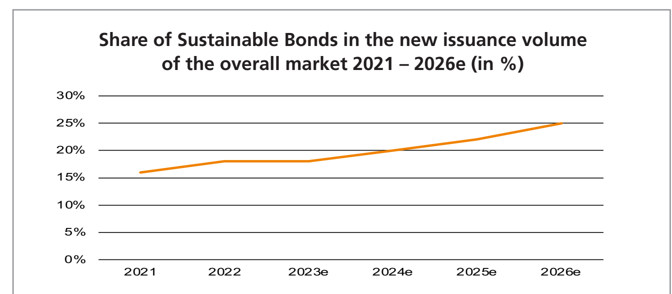
Source: DZ BANK

With an estimated share of 64%, the Green Bond segment will remain solid anchor of the market in 2023. Together with Social Bonds (15%), Sustainability Bonds (16%) and the few Transition Bonds, Use-of-Proceeds Bonds will remain the dominant structure in the Sustainable Bond market with around 95%.



Source: DZ BANK

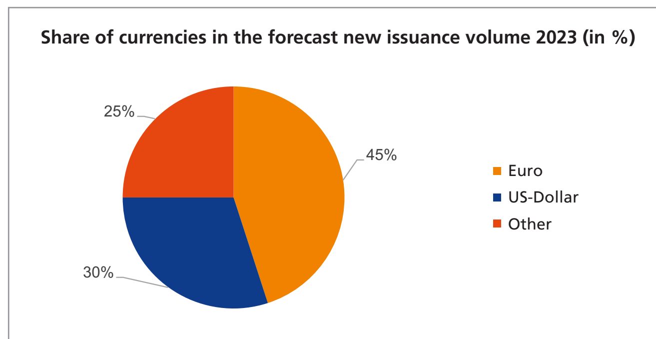
In our view, the share of Sustainable Bonds in the new issuance volume of the overall market should remain stable at around 18%.



Source: DZ BANK

Around 75% of the new issuance volume of Sustainable Bonds will be dominated by Euro and USD-denominated transactions in 2023, with the Euro remaining the preferred currency at around 45%. The attractiveness of the Euro as the preferred issuing currency is partly due to the high number of dedicated sustainable and responsible investors in Europe.

Share of currencies in the forecast new issuance volume 2023 (in %)



Source: DZ BANK

A first look at the bigger picture: Back to new growth records?

As investor appetite for Sustainable Bonds continues unabated, we expect a gradual return to growth in all segments over the next 12 to 18 months. The percentage growth of Sustainable Bonds should again exceed the percentage growth of the traditional bond market in 2024. The share of Sustainable Bonds in total issuance will continue to rise (2024e: 20%) and will be more than a quarter in a few years.

In 2024, the Sustainable Bond market is likely to break new growth records, at least in individual segments such as the Green Bond segment. Besides, we expect further diversification by issuer, structure and theme as we move throughout 2024.

We forecast a further increase in issuance from emerging markets. Additionally, we also expect a strong issuance pipeline of Sovereign Sustainable Bonds, as both first-time issuers are in the starting blocks and established issuers expand their sustainable finance activities. In addition, smaller sovereign issuers, for example in Southeast Asia or Latin America, are likely to show increasing interest in target-linked structures.

Sustainable Sukuk is likely to become an important issuance theme in some regions of the world, as government initiatives to promote sustainability and economic diversification are continuing in several Organisation of Islamic Cooperation (OIC) countries, and demand and awareness among issuers and investors has increased. Also, more issuers are likely to engage with the issue of Sustainability-Linked Loan Bonds (SLLB's), where the proceeds are not earmarked for green loans or assets but rather Sustainability-Linked Loans.

Furthermore, we expect nature-related risks to move further up on the agenda of Sustainable Bond issuers. By bringing Sustainable Development Goals (SDGs) such as „Life on land" (SDG15) and „Life below water" (SDG14) into the focus of sustainable finance, the groundwork will be laid for more and more transactions focusing on biodiversity, marine economics, and other nature-related issues.

News from the Principles

On 22nd June 2023, the Green, Social, Sustainability and Sustainability-Linked Bond Principles (Principles) announced the 2023 editions of the Climate Transition Finance Handbook (CTFH) and the Sustainability-Linked Bond Principles (SLBP) as well as of the accompanying Key Performance Indicator (KPI) registry.

Climate Transition Finance Handbook (CTFH)

The most significant update is to the CTFH, which now places greater emphasis on alignment with an issuer's greenhouse gas (GHG) emissions reduction strategy and the goals of the Paris Agreement. There is also an increased focus on disclosure and transparency.

Regarding the core elements of the CTFH, adjustments were carried out rather in details, which may, however, also mean material differences in the result. Looking at element 1 "the issuer's climate transition strategy and governance" the CTFH recommends now also the review of the level or type of independent governance and oversight of an issuer's climate transition strategy.

For the 2nd element "business model environmental materiality" the update now includes, among others, recommended information and indicators that discuss the materiality of the planned climate transition strategy. This may be addressed by a materiality matrix or the impact of the climate-related eligible projects and/or KPI(s) on the overall emissions profile of an issuer.

Disclosure was also a key point for adjustments of the 3rd element "climate transition strategy and targets to be science-based". In its previous version, the CTFH only provided a list of suggested information and indicators for disclosure. In the current version, the CTFH emphasized this topic by having strongly recommended information and indicators. Those indicators now also include, in addition to the ones from the

previous version, use of carbon capture technology as well as of high-quality and high-integrity carbon credits, and their relative contribution to the GHG emissions reduction trajectory, where applicable.

Regarding the "implementation transparency", the 4th element, the CTFH now also highlights the role of those companies in the so called "hard-to-abate" sector and their need to announce GHG emission reduction strategies, targets, and related commitments. Major adjustments were again made for the disclosure, where the CTFH now provides an extended list of recommended information and indicators, such as phase-out plans for those activities or products that are incompatible with the climate transition strategy. Furthermore, a qualitative and / or quantitative assessment of potential locked-in GHG emissions from an issuer's key assets and products and assumptions on the internal cost of carbon are also outlined. For the independent review, the updated CTFH now also gives a list of potential dimensions that can be reviewed, such as the percentage/relative share of green/sustainability spending out of an issuer's total spending, or the absolute amount of green/sustainability spending, or the GHG emission reduction outcomes or achieved / expected benefits through such increased spending.

Furthermore, the new CTFH now incorporated an appendix where it provides illustrative examples of issuance disclosures for the various elements distinguished between the application to use-of-proceeds and sustainability-linked instruments. The annex 1 summarises the CTFH's key recommendations in the form of an infographic and annex 2 provides a non-exhaustive list of existing taxonomies and official sector guidance that may be used in support of climate transition-themed financial instruments. Usually, these resources complement each other and can be combined.

Sustainability-Linked Bond Principles (SLBP)

The SLBP and the related Key Performance Indicator (KPI) registry have been updated during this process. One main feature that has been reflected now in the SLBP is the adoption of the language for sovereign issuers and the new metrics for sovereign and social issues in the KPI registry. Language adjustments are mainly reflected in the core components 1 – selection of KPIs (e.g. social and governance policies for sovereign issuers), 2 – calibration of Sustainability Performance Targets (SPTs) (e.g. consistency with the sustainable development policies in the case of sovereign issuers), and 4 – reporting (i.e. alternatives for sovereign issuers if quantitative data is not available). The KPI registry now includes an extensive list of potential KPIs with the related global benchmarks, Sustainable Development Goals (SDGs) and the EU objective that is supported by the KPI.

Additional updates and guidance

Furthermore, the Principles have also released several updates and revisions, specifically:

- Additional Q&As for green, social and sustainability bond securitisation;
- Revised language for the Social Bond Principles (SBP) confirming notably the need to identify target populations, and separately, specific guidance for impact reporting for Social Bonds;
- Updates to the core recommendations for impact reporting for Green Bonds, and impact reporting metrics for energy efficiency & renewable energy;
- A revised mapping to the SDGs; and
- Updated issuer information templates and external review forms.

DZ BANK voted as new Executive Committee member of the Principles

In addition to the updates of the Principles and the related guidance and information, the Principles also announced the renewal of half of the 24 members of its Executive Committee following its annual vote according to its governance. DZ BANK is honoured to have been elected as one of the new members of the Executive Committee of the Principles.

New Guidance on Blue Bonds

Most recently, the International Capital Market Association (ICMA) together with the International Finance Corporation (IFC), United Nations Global Compact (UN Global Compact), United Nations Environment Programme Finance Initiative (UNEP FI), and the Asian Development Bank (ADB) have published a global "Practitioner's Guide for Bonds to finance the Sustainable Blue Economy". The voluntary guidance provides market participants with clear criteria, practices, and examples for "blue bond" lending and issuances. Based on the Principles supported by ICMA and gathering input from the financial markets, ocean industry and global institutions, it provides information on the key components involved in launching a credible "blue bond", how to evaluate the environmental impact of "blue projects" and the steps needed to facilitate transactions that preserve the integrity of the market.

The new global guidance helps:

- Define blue economy typology and eligibility criteria;
- Suggest key performance indicators;
- Showcase latest case studies from the field; and
- Highlight the critical need for increased financing to achieve Sustainable Development Goal 14 and other global sustainability targets.

The guidance builds on existing market standards that underpin the global Sustainable Bond markets such as the Green Bond Principles and also draws on pre-existing specific blue guidance.

Source: DZ BANK, Principles, ICMA

Identifying credible agricultural transition plans

Key Points

1. Agriculture needs finance to become more resilient to, and to mitigate, climate impacts.
2. Transition plans are vital tools for all entities to plan out and raise the necessary finance to transform their business model to become climate resilient and environmentally sustainable.
3. Guidance regarding transition plan credibility is important to support ambitious action and enable financial actors to identify the most progressive agriculture investments.
4. Transition plans are becoming mandatory in many jurisdictions.
5. Credible transition plans are transparent, require full material scope coverage, ambitious performance targets linked with science-based pathways and should not depend on offsets.

Summary

As GHG emissions continue to rise across all major sectors globally, there is a growing recognition that finance in support of climate mitigation goals needs to be scaled up and be consistent with a pathway towards a low carbon economy. This means that finance must take a dynamic and forward-looking view of companies' decarbonisation journeys and be inclusive, covering all sectors. Climate transition finance refers to finance earmarked to fund the process of decarbonising an organisation's business model.

One of the core tools to deliver the global transition to net zero is a credible transition plan outlining the steps that will be taken to shift the business model to align with a 1.5-degree future. Emerging regulations in the EU, Japan and UK are mandating the development and disclosure of transition plans. Organisations such as Climate Bonds, Transition Plan Taskforce, ACT (Assessing low-carbon Transition) Initiative and Transition Pathway Initiative have published detailed guidance to help private sector actors understand the elements that need to be included in transition plans. Sector-specific guidance is now also starting to emerge linked to sector specific pathways and decarbonisation measures.

Definition of a Transition Plan

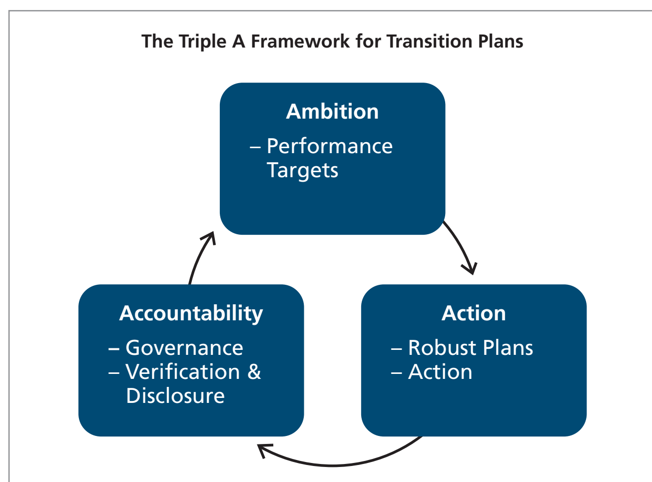
An action plan for an entire entity that identifies how the business will transform itself to align with the latest science-based transition pathways. The aim is to cut GHG emissions in half by 2030 and reach net-zero by 2050 at the latest, to limit global warming to 1.5°C.

This short paper will indicate what to look for in an agri-food transition plan in order to help stakeholders from both the corporate and financial sectors identify credible, low carbon and sustainable investments and direct finance accordingly.

In essence, all transition plans need to have relevant key performance indicators (KPIs) with short-, medium-, and long-term measurable performance targets aligned with science-based sector pathways. The levers for change must be identified and costed with a clear implementation and monitoring plan in place linked to a strong internal governance structure that is positioned to deliver change. In agriculture these could include reducing emissions from livestock production through sourcing deforestation-free feedstocks, increasing plant protein product offerings and optimising fertiliser use. Agrifood production companies are in a unique position as they can both cut their greenhouse gas (GHG) emissions as well as increase the uptake of carbon and boost the health of underlying ecosystems through improving soil health and enhancing natural spaces on farms. As such, for agri-food companies, additional KPIs addressing climate resilience and measuring positive impacts on water, social wellbeing, biodiversity, and chemical inputs should be considered.

Introduction

Our agriculture and food systems are extremely vulnerable to climate impacts. Changes in rainfall and temperature patterns as well as more severe and frequent storms have already led to significant crop losses for farmers across the world. To build resilience and the ability to adapt to



Source: Climate Bonds Initiative

predicted climate impacts, farmers and companies need practical guidance combined with financial support from informed investors. Banks such as DZ BANK have a vital role to play working across the agri-food sector to finance the transition to a sustainable food system.

Climate Bonds Initiative (Climate Bonds) is a non-profit organisation working to mobilise global capital for climate action. We define and demonstrate the opportunities inherent in credible investments (including use of proceeds bonds, sustainability linked debt and general purpose finance) to enable investors to identify and channel finance to climate leaders.

Transition plans are a core tool for finance. Companies need them in order to identify the opportunities and risks from climate change on their business model and plan how to finance and transform operations to align with a sustainable future. In turn, financial institutions use these corporate transition plans to identify credible partners and investments. Government bodies are also using transition plans as a tool to identify actors to receive subsidies and incentives for transition activities [1].

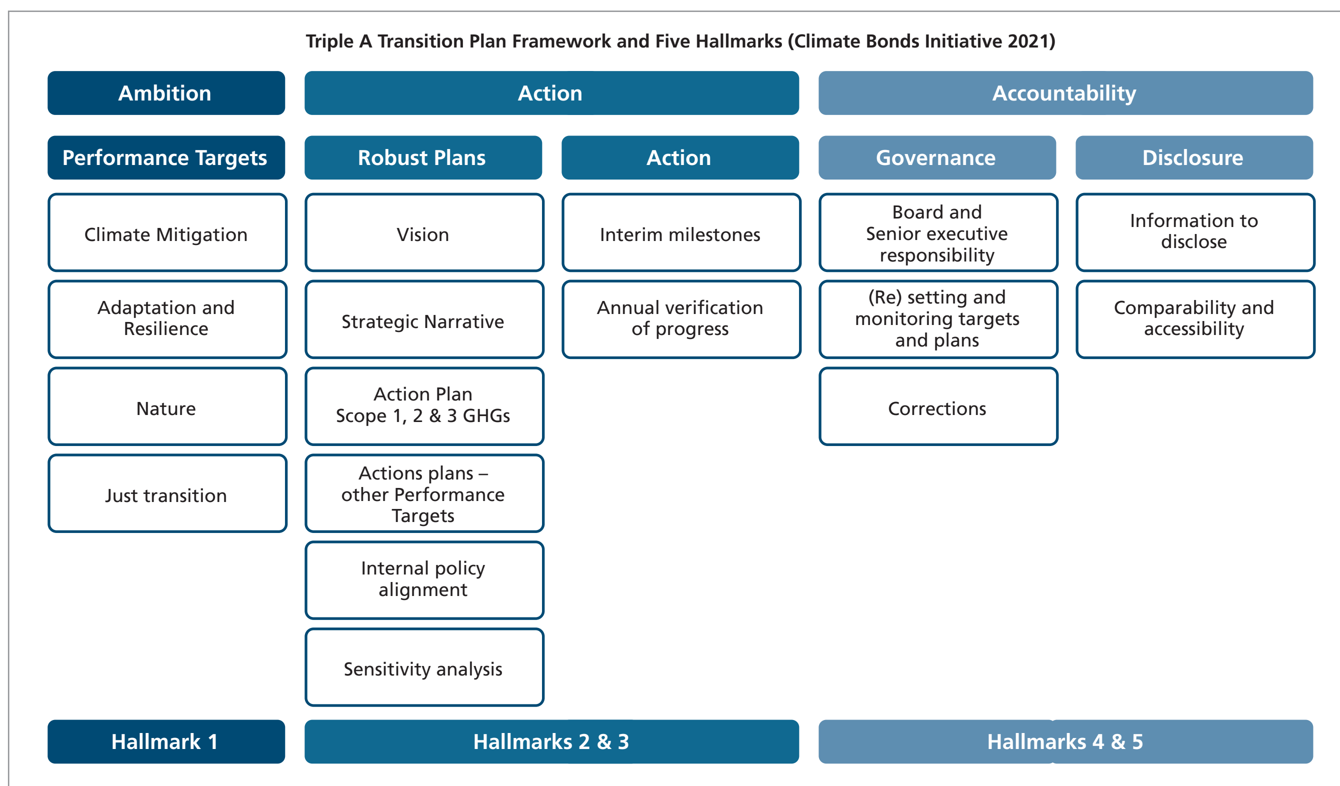
To support market actors to recognise credible transition plans, Climate Bonds developed a framework setting out the requirements for transition plans and how to assess them. The framework builds on **Transition finance for transforming companies (2022),** links to the **Climate Bonds Standard Version 4** and is underpinned by the sector criteria discussed below.

Transition plans must cover five elements (the **Five Hallmarks** [2]) that describe the willingness and ability of an entity to transition. The Five Hallmarks in turn are captured by the **'Triple A'** framework of Ambition, Action and Accountability.

Identifying credibility and the Five Hallmarks

Hallmark One sets out the need for transition plans to have relevant KPIs and linked performance targets aligned with science-based sector pathways that identify the speed of decarbonisation needed to stay within 1.5 degrees of warming. KPIs of specific relevance for companies involved in the agri-food sector include full scope 1, 2 and 3 emissions, water management, biodiversity and pollution targets as well as food loss and waste. Social elements such as healthy food and a just transition may also be relevant.

Currently there are decarbonisation pathways available from SBTi [3], IPCC [4], CGIAR [5] and Climate Bonds [6] for agricultural commodities and production systems. The current **Climate Bonds criteria for Crop and Livestock Production** provide both a decarbonisation pathway



Source: Climate Bonds Initiative

1) https://eipie.eu/wp-content/uploads/2022/07/IED-briefing_innovation_v01_15July2022.pdf
2) https://www.climatebonds.net/transition-finance-transforming-companies
3) https://sciencebasedtargets.org/sectors/forest-land-and-agriculture
4) https://www.ipcc.ch/site/assets/uploads/sites/2/2019/02/SR15_Chapter2_Low_Res.pdf
5) https://www.nature.com/articles/s41598-022-18601-1
6) https://www.climatebonds.net/standard/agriculture

and clear guidance for the measures that can be taken to ensure farming practices deliver climate impact. These measures include changes to tilling and planting practices, optimising fertiliser applications, the use of ground cover crops and avoiding land clearance. Climate Bonds are now working to update these criteria to provide more guidance on biodiversity, water use, just transition as well as specific measures to decarbonise commodity value chains and improve procurement practices in the agri-food system. The measures included in the updated criteria will also support corporate actors to deliver on the due diligence requirements within the new EU deforestation regulations (EUDR) and provide a clear signal for investors that the company presents a credible investment.

The updated criteria will be published for consultation in early 2024 and allow for the climate certification of sustainability-linked debt, use of proceeds-bonds as well as entities with credible transition plans. Additional criteria for the full food value chain, to allow the certification of operations and entities from farm to fork, are under development. These new criteria will provide clear guidance for measures to ensure deforestation and conversion-free production as well as meeting water use, food loss and waste and packaging efficiency best practice.

Hallmark two lays out the vision of the future business model and the main levers of change that will be employed to get there. These could include changes in product mix, supply chain mapping and exclusion of commodities associated with deforestation, committing to responsible sourcing, switching to renewable energy and employing energy efficiency measures. Hallmark two needs to include action plans to meet all the identified performance targets across the supply chain, a supply chain engagement strategy, as well as a solid finance plan. **Hallmark three** is all about demonstrating the short-term progress on these plans.

Hallmarks four and five provide internal and external transparency. Hallmark four sets the internal governance structure and leadership needed to deliver on the transition whilst **Hallmark five** requires annual public disclosure on progress against the transition plan.

More information on the red and green flags for each hallmark and how to certify a transition plan can be found **here.**

Benefits of transition plans and sustainable finance

Preparing a transition plan can involve significant amounts of work, mapping out emissions and vulnerabilities across all operations in order to identify opportunities for improvements. Financing the transition can be another hurdle, investors and banks may be hesitant to invest in unproven business plans or new technologies.

However, the process of developing a transition plan requires senior level oversight and leadership which ensures c-suite understanding of the opportunities and threats presented by climate change, transition, regulations and changes in demand. This allows the business to position itself for success, mitigating risks and maximising opportunities. Transition plans also provide a foundation for transition finance. Governments and financial actors are increasingly using transition plans to identify credible partners and projects to fund and collaborate with. Sustainable finance is often lower cost finance, giving access to a greater range of 'stickier' investors and opening new doors for new collaborations.

Case Study: FrieslandCampina Transition plan and sustainability linked financing framework [7)]

FrieslandCampina is one of the largest cow milk dairy cooperatives in the world. The company has a sustainability-linked financing framework linked to its transition plan. In 2023, the company used that framework to raise a EUR300 million sustainability-linked bond, a general purpose finance instrument with linked predefined Sustainability / ESG objectives.

Targets: (Hallmark 1)

- Carbon neutral by 2050. 2030 GHG emissions reduction targets (63% reduction in absolute scope 1 and 2 emissions, 37.5% reduction in absolute scope 3, from a 2015 baseline). Note – this would benefit from an interim target for 2025 to track progress.
- By 2030; conversion free commodity and raw material supply chains. Note – this would benefit from an interim target for 2025 to track progress.
- 95% recycling-ready packaging by 2025 from a 2021 baseline. Note – this would benefit from also reducing packaging use, tackling resource loss and waste management in the supply chain [8)].

FrieslandCampina used a 1.5 °C pathway with its 2030 decarbonisation targets validated by the Science Based Targets initiative (SBTi).

Plan: (Hallmark 2)

Electrification, fuel switching to renewable energy including biogas generated on site. Note - biogas is only a good fossil fuel substitute when feedstock is limited to residues, the origin of the feedstock should be disclosed. For upstream scope 3 emissions, levers include deforestation and conversion free (DCF) feed production, breeding programmes and feed supplements to reduce enteric fermentation, improved housing systems and manure management. Finally, the company clarified that no offsets are used to reach its 2030 targets.

Action: (Hallmark 3)

Upstream value chain engagement to reduce further scope 3 emission reductions and implement deforestation and land-conversion free policy, reduce water consumption and pollution and increase recycling. The

7) https://www.frieslandcampina.com/uploads/2023/03/Sust-Finan-Framew-FrieslandCampina-v7.pdf
8) https://www.frieslandcampina.com/uploads/2023/02/Assessment-Royal-FrieslandCampina-NV-13Feb23.pdf

company is also monitoring farm biodiversity. Capex and Opex investment plans are established until 2026, future state subsidy schemes are integral to finance part of the cost.

Governance: (Hallmark 4)
Sustainability is embedded in the company strategy: the board of the company supervises the executive board and signs off the performance objectives of the company. The executive board is responsible for the sustainability policy implementation, monitors it and reviews it every six weeks.

Disclosure: (Hallmark 5)
Annual disclosure based on the Greenhouse Gas Protocol, with reports audited by an external auditor for limited assurance. Measuring scope 3 emissions is noted as challenging and is currently not comprehensive. In the interim, emission measurements can be transparently defined, using a consistent methodology such as the greenhouse Gas Protocol that can be benchmarked and verified to demonstrate credibility and facilitate access to transition financing.

Case Study: Landwirtschaftliche Rentenbank; Energy from the Countryside programme [9]
Bank lending is an important source of agricultural and sustainable finance. Landwirtschaftliche Rentenbank ('Rentenbank') is Germany's development agency for agribusiness and rural areas. Rentenbank has a comprehensive sustainability strategy which supports sustainable agriculture investment and interest rate subsidy programmes [10]. With its 'Sustainability', 'Environmental and Consumer Protection', and 'Forestry' programmes, Rentenbank supports a wide range of measures to improve animal welfare, energy efficiency, and emissions reduction.

In 2023 Rentenbank published its updated Green Bond Framework applied to finance projects in the 'Energy from the Countryside' programme, focused on investments in photovoltaic, biogas, and wind power generation. The loans financed through this programme must be for new or existing activities that are part of a list of eligible activities:

- Generation, storage and transmission of onshore wind energy, for instance wind turbines operated by farmers or companies which are at least 50% owned by agricultural shareholders, community wind farms run by companies that are at least 50% owned by local residents etc.
- Generation, storage and transmission of solar energy, for instance photovoltaic installations belonging to farmers or undertakings with at least 50% in agricultural holdings.
- Generation, storage and transmission of biogas-based energy.

Conclusion

Transition plans are a valuable tool for both corporate and financial actors looking to decarbonise their business models. Understanding the core elements of transition plans is necessary for corporate leaders to ensure their plan is of high quality and position themselves to deliver on their commitments. Public and financial sector actors must also have the skills to assess the credibility of transition plans in order to understand the decarbonisation potential of investments. Transition plans have become an established requirement for companies within the UK, EU and Japan through existing and emerging regulations such as the Corporate Sustainability Reporting Directive (CSRD), Industrial Emissions Directive (IED) and the upcoming Corporate Sustainability Due Diligence Directive (CSDDD). Harmonised guidance and metrics are important to enable comparability between companies and plans. Climate Bonds has worked closely with other thought leaders in the space to ensure our Five Hallmarks of transition plans, as well as the linked sector criteria, are fully aligned with and build on the main guidance to market.

ESG Rating Providers: What's cooking?

The significance of ESG ratings in the financial market has grown significantly over the past few years. They have become important sources of information for investors and financial institutions and are also used by companies to better understand their own sustainability risks and factors, or to better analyze competitors. The market structure of ESG rating providers is fundamentally very different from that of traditional credit ratings, although ESG ratings are sometimes offered by the same financial market participants.

Traditional credit ratings have a very high correlation and are very homogeneous in terms of methodology and results, which is not the case for ESG ratings. ESG ratings come to very different assessments and results and have low correlations.

The market of ESG rating providers is growing strongly, which has led to a high level of M&A activity in the sector over the last few years. Meanwhile, the major providers such as MSCI or Moody's have acquired several specialized ESG rating providers. It is interesting to consider that, despite its significance for the financial industry, the topic of ESG ratings has not really been regulated yet. However, it is expected that this problem will be solved at European level, and European Commission and ESMA have now taken a clear position on this issue.

9) Rentenbank-Green-Bond-Framework-May-2023.pdf
10) https://www.rentenbank.de/en/documents/DNK_2020_Landwirtschaftliche-Rentenbank.pdf

ESG Ratings: Important investor tool

But first, let's look back to better understand the ESG ratings market. Sustainable investing, i.e. investing that takes into account so-called ESG (Environmental, Social & Governance) factors, has become a major trend in the financial industry over the past few years. The share of so-called „sustainable" funds has risen sharply, and more and more capital is flowing into these types of investments. This has also led to the development of a so-called ESG ecosystem around the sustainability trend, which also includes the providers of ESG ratings. These have become a very important tool for investors and other stakeholders in order to become knowledgeable about sustainability risks and factors of investments. In addition, ESG ratings are increasingly being incorporated into businesses' risk management processes, and investors are also using ESG ratings to comply with EU disclosure obligations required by law.

Investors often rely on more than one rating provider or build ESG ratings into their own adapted ESG investment processes. They often serve as the first source of information with regards to the sustainability risks of a company or issuer. In addition, an ESG rating also has a clear mandate to initiate further ESG work on the investor side in case of discrepancies or discussion points.

ESG Rating Providers – Transparency as a major challenge

There are a number of weaknesses in the current shape of the ESG ratings market that we would like to examine in more detail. The EU is fully aware of these market shortcomings and has started to take a closer look at the ESG rating provider market since 2021, but especially since last year.

ESMA (European Securities and Markets Authority) launched a „Call for Evidence" as early as 2022 in order to take a closer look at the market of ESG rating providers in the EU and to examine size, structure and supply. In this context, users of ESG rating providers were also asked for their feedback, and this revealed many shortcomings.

For example, there is a lack of clarity on the part of market participants as to how the word ‚ESG' is to be understood in the first place and what actual purpose an ESG rating addresses. Furthermore, there are questions regarding the lack of transparency of the rating methodologies used by the respective provider, as well as regarding the lack of standardization with regards to ESG data used. Another point of negative concern for many market participants is the rising price levels for the services offered by providers. The strong M&A activity in the sector over the last few years has led to strong pricing power, which is viewed with suspicion from the perspective of rating users. Other critical issues also include the late processing of new ESG data, and often the lack of availability and accessibility of rating providers in terms of general communication or content-related error fixes.

At the same time, the European Commission launched a consultation last year on the ESG ratings market in the EU and the inclusion of ESG factors in traditional credit ratings. The aim on part of the EU is also to provide clarity here as to whether the objectives of the EU Green Deal can be achieved with the current market structure, or whether further political initiatives are required. The results of the EU consultation were published in August last year, and the vast majority of market participants sees an urgent need for action on part of the EU in the form of necessary legislation. Particularly, criticism was voiced with regards to market structure, possible conflicts of interest on the part of ESG rating providers, and a lack of transparency in ESG rating methodologies.

Among other things, this clear feedback prompted the European Commission to initiate further political measures and to adopt a new Sustainable Finance package of measures in June of this year. Within this framework, new EU taxonomy criteria were published on the one hand, however, in the context of the wider ESG ratings market, significant improvements were communicated in the area of ESG ratings.

The EU Commission has now submitted a regulatory proposal for the providers of ESG ratings. For example, the transparency requirements for providers are rising sharply, and they will be required to be authorized to conduct business activities in the EU, while being monitored by ESMA. Furthermore, clear rules for avoiding conflicts of interest will be created, and ESG rating providers will have to disclose their methodologies. The primary goal is to make these more transparent, and not to harmonize approaches, because the market of ESG rating providers should remain diverse and serve the analysis, also of different sub-aspects, in the ESG market. Ultimately, the aim is to be able to provide users, such as investors, with high-quality information to create a transparent and fully comprehensive information base for the analysis of ESG factors. The same is also the case for rated companies, which need to have a transparent overview of ESG impacts, opportunities and risks. Similarly, companies must not rely on the more favorable assessment of a particular ESG rating; to this end, minimum requirements for ESG ratings are to be defined.

Ultimately, the European Commission wants to create clear market conditions to underpin the goals of the EU Green Deal. The new initiative shows a clear path towards more regulation of ESG rating providers, which is supported by an overwhelming majority of market participants and which will ultimately also strengthen the market for sustainable investing.

Medium-term implications for all market participants

From a practical perspective, this means ESG rating providers will have to revise and question their processes. Here, it is also important to create clear demarcations in the event that potential conflicts of interest lurk, as is the case with ESG rating providers who also offer traditional credit ratings. Internal control mechanisms as well as adequate com-

pliance processes are required here, so-called „Chinese walls". In theory, this can also mean separating parts of the company from each other, especially in the case of large providers. If potential conflicts of interest cannot be resolved, it will be necessary to discontinue the business activities in question. ESMA will continue to develop regulatory technical standards (RTS) to further define methodologies for ESG rating providers.

For investors, the planned measures mean improved transparency and visibility, including for their own ESG processes. Similarly, the move towards regulation may also lead to a significant reduction in dependence on ESG rating providers in the medium term, as the quality of standardized ESG information available in the market will increase. The planned policy measures should also be considered in close interaction with other EU sustainable finance regulations – in addition to the EU Taxonomy Regulation or the EU Disclosure Regulation, for example, also the EU Credit Ratings Regulation, the EU Benchmark Regulation, and the EU Green Bond Standard.

All regulations serve to strengthen the European market for sustainable investments and underpin the EU's clear commitment to the goals of the EU Green Deal. The next few months will show how quickly progress is made. At the earliest, a finalization of the technical regulatory standards for ESG rating providers can be expected in mid-2024. However, this target seems quite ambitious, also due to the upcoming EU parliamentary elections next year.

Source

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