Università di Genova | DIGI DIPARTIMENTO DI GIURISPRUDENZA

Information Intermediaries and Sustainability: ESG Ratings and Benchmarks

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ECMI Annual Conference – 9 November 2022

What is the paper about?

- **Information (or reputation) intermediaries play a crucial role in ESG finance**
  - Many investors rely on information intermediaries when making decisions
  - Making sure that they are properly regulated is key to supporting sustainability in the financial sector

- **We focus on two types of information intermediaries only**
  - ESG ratings
  - ESG benchmarks

Why a paper on ESG ratings and benchmarks?

- **In traditional finance, ratings and benchmarks rely on well-established rules**

- **This is not necessarily the case with their ESG equivalent**
  - ESG ratings are not “ratings” under EU law
  - ESG benchmarks are “benchmarks” under EU law, but they raise specific problems

- **Unchartered territories increase the risk of regulatory mistakes**
  - Natural tendency to take inspiration from existing rules
  - Can this lead to availability bias?

Research question(s)

- How do market failures affecting ESG ratings and benchmarks compare to those affecting their traditional equivalents?
  - A positive analysis

- How much do or should the new rules mirror the old ones?
  - A normative analysis

Analytical framework

- Information intermediaries are tools to address market failures but they are subject, in turn, to their own failures

Outside-in

- Some specific methodological issues (e.g. distinct 'garbage in, garbage out' problems)

Inside-out

- "Pure" ESG perspective – new approach

ESG ratings: challenges

- Methodologies inevitably imbued with discretional assessments
- Relationship with issuers and market structure
- Consistent literature highlights low level of correlation among ESG ratings
- Avoiding regulatory incentives
    - SFDR and benchmark regulation: good job!

ESG ratings: market-driven reliance

- **However, need for simplification of complexity remains**
  - Economies of scale in ESG assessment
  - Availability heuristics absent easy alternatives

- **Market practice: recourse to multiple ESG ratings**
  - Measuring different things or lack of trust? Apparently both
  - Active investors are reportedly reducing reliance and developing proprietary assessment tools – what about passive ones?

ESG benchmark: a robust framework

- **ESG benchmarks: define a subset of investable universe based on ESG criteria**
  - Performance figure as a yardstick for active ESG managers
  - Composition replicated by passive ESG managers

- **Methodology disclosure includes indication of ESG objectives, if any**

- **Special labels for ESG benchmarks (decarbonisation trajectory 7% yearly)**
  - EU Climate Transition benchmarks (carbon footprint 30% lower than investible universe; some exclusions mandated, policy for others)
  - EU Paris-aligned benchmarks (carbon footprint 50% lower than investible universe; max 2º above pre-industrial level; tighter exclusion criteria)

Stocktaking: market failures in the ESG world

- **Exacerbated asymmetric information**
  - Role of infomediaries reveals hard access to direct information
  - Lack of expertise on ESG matters still pervasive → may increase reliance

- **Exacerbated risk of regulatory failures**
  - Still little is known about optimal ESG metrics and their impact
  - Weak market mechanisms do not offer corrective systems

Policy implications (i)

- **Things we can be sufficiently confident about:**
  - Disclosure duties on methodologies and conflict of interest may help

- **Things we are more uncertain about:**
  - “Option zero” does not seem viable

  - Should we go “all in” and take inspiration from CRAs?
    - A registration regime may paradoxically lead to regulatory-induced reliance
    - Baby step approach may be advisable in uncharted territories

Policy implications (ii)

- **Regulation is inevitably path-dependant, so the best attitude may be to just look for the right source of inspiration**

- **Other viable alternatives?**
  - Proxy advisors (we do not consider them)
  - Financial analysts

- **The pros of the financial analyst framework**
  - No registration: less regulatory-induced reliance
  - COBs that focus on disclosure of COI and performance
  - Calibration of COBs depending on impact (“experts” and supervised entities vs others)

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