SOCIÉTÉ FRANÇAISE
DES ANALYSTES
FINANCIERS

ESMA
201 203 rue de Bercy
75012 Paris

March 11, 2022

Call for evidence on Environmental, Social and Governance (ESG) ratings.
SFAF Response

Dear Madam, Dear Sir

The French Society of Financial Analysts, SFAF (Société Française des Analystes Financiers), is pleased to submit its contribution as part of the "Call for evidence on ESG ratings".

SFAF represents more than 1,300 members in France and is itself a member of the European Federation of Financial Analysts Societies (EFFAS), which comprises 18 member organizations representing more than 15,000 investments professionals.

The SFAF Extra-Financial Analysis Commission (https://www.sfaf.com/les-travaux-et-commissions/commission/99-commission-analyse-extra-financiere) has over 70 people working in all areas of expertise, analysis and management in the various E, S and G sectors.

Its work is supported by 5 working groups (Governance, Impact Investing, Integrated Performance Analysis, ESG Barometer, Purpose, Integrated Report and ESG-CESGA Certificate Training).

For these reasons, our Society, through its Extra-Financial Analysis Commission, is keen to respond to your call for evidence.

However, its response will be limited to the only two questions in recital "6.1.6 General views on ESG ratings in EU Financial Markets".

Q1. Please provide your views on the level of relevance of ESG ratings to EU financial markets and financial market participants. Do you consider this level will increase in the coming years?

The financial and extra-financial analysis of a listed company has evolved a lot in recent years and analysts are increasingly integrating the elements of extra-financial analysis more rigorously into the study of a company. The valuation of a society increasingly takes into account non-financial issues.

The relevance of ESG ratings will increase under two conditions:
- Transparency on how the score or score is produced;
- Proper use of the rating as a decision aid and not a decision factor.

SOCIÉTÉ FRANÇAISE
DES ANALYSTES
FINANCIERS

1.1 Rating versus analysis

The ESG score is very often used as a decision factor and not as a decision support tool as it should be. The problem is not the ESG rating itself, but the use that is made of it. Thus, the ESG rating should not be seen as an extra-financial analysis, which may seem to be the case at the moment. The ESG rating is based on past performance and the issuer's strategy is the basis of the analyst's work.

Current regulations do not address this issue. On the contrary, it tends to reinforce the "compliance" role of the rating, in relation to its decision-support role (e.g. demonstrate in the SFDR report that the portfolio has a better score than the benchmark universe, and so on...).

Some investors stop at this rating without seeking to know the fundamentals of the company, its activity, its growth.

The development of the ESG rating is thus perceived as approaching more of a "credit rating" type than an "equity analysis" type. It favours risk and therefore compliance at the expense of fundamental analysis.

1.2 A movement amplified by the development of passive ESG management

ESG ratings have grown in importance with the development of passive management as ESG indices are based on stock selection based on ESG scores.

In many cases, the extra-financial data is not available and is replaced by more or less precise models. This imprecision, on climate data for example, will intensify with the need to publish information on biodiversity, climate trajectories, …., whose collection and processing methodologies are by nature based on models and approximations.

We can therefore worry about the selection role given to ESG scores, built on data in itself, are rather decision aids than information to be taken literally.

1.3 Recommendations

a) **It is necessary that future regulations**:

- **must not reinforce the simplistic use of the notation**, that is, as an in/out selection tool.
- **should not freeze the ongoing experimentation process** and should allow for the flexible evolution of rating methodologies, which are not yet fixed.
- **should not raise barriers to entry for new players** in rating, which would be counter to healthy and transparent competition for research emulation.

b) **It is necessary that the score production model must be transparent**.

b) **It is necessary to obtain transparency on the degree of precision of the basic data used**: raw data, recalculated data or estimation? With regard to estimates, the regulations should also ask about the models used for, for example, estimating environmental data (e.g. temperature, Scope 3).

SOCIÉTÉ FRANÇAISE
DES ANALYSTES
FINANCIERS

Q2. Please provide your views on the level of risk ESG ratings currently pose to orderly markets, financial stability and investor protection in the EU. Do you consider this level will increase in the coming years.

The ESG rating covers different types of risks:

- The risk of a green bubble
- The risk of being excluded from companies that do not have the material means to obtain good scores,

2.1 Green bubble risk

The risk of a green bubble is amplified by regulations that drive investors to higher-rated companies in small numbers. This risks creating a decoupling between this buying pressure and the real economic value of the issuers. The lack of diversification of some green funds can also be a risk.

2.2 Decoupling with the transition needs of the economy

In addition to low-rated sectors, SMEs that do not have the human and/or financial means to ensure good scores are at risk.

2.3 Decorrelation between regulation and rating methods

European regulations (NFRD) require companies to publish ESG information relevant to their business model, on the basis of a double materiality analysis.

The rating suffers from a long-known transparency bias (the companies with the highest ratings are those that produce the most information).

On the other hand, the subject of climate (whatever the activity of the company, its impact and its leverage of action) is predominant over all the others in European regulation. This focuses investors' attention on the E score, and more specifically on the companies' climate performance, whether relevant or not.

Again, the simplification brought by scores or ratings is welcome in the complex world of ESG, **but it must not override other types of ESG analysis, more fundamental.**

We thank you for the opportunity given to us to provide our view on such important aspects of notations ESG for professional users. If you would like to further discuss the views expressed in this letter please do not hesitate to contact us.

Yours faithfully,

Bruno BEAUVOIS	Corinne BAUDOIN	Martine LEONARD
Consultant	Vice Chairwoman of the Commission non-financial analysis	SFAF's Chairwoman