30 November 2023

Sustainable Finance Unit
Climate and Energy Division
The Treasury
Langton Crescent
PARKES ACT 2600

BY EMAIL

Dear Madam or Sir,

RE: Sustainable Fitch's response to the Government's consultation on Australia's Sustainable Finance Strategy (the "Consultation")

Sustainable Fitch appreciates the opportunity to review and comment on the Consultation. We set forth below our initial views and observations in response to the statement contained in the Consultation that *"The Government will consider feedback on whether ESG ratings should be captured by financial services regulation, comparably to credit ratings agencies"* and the related question *"Is there a case for regulating ESG ratings as financial services?"*. Sustainable Fitch would appreciate the opportunity to comment on any subsequent proposals for specific obligations in due course. Sustainable Fitch has no objection to the submission being available to the public on the Treasury website.

Overarching Position

Consistent with international developments, Sustainable Fitch supports the establishment of minimum standards in relation to the provision of ESG ratings to issuers and subscribers within Australia. Similar to regulations regarding credit rating agencies, regulations with respect to ESG rating providers should ensure the independence of those providers, including by requiring that conflicts of interest be identified and either eliminated or adequately managed, and should specify minimum levels of disclosure around methodologies and ESG ratings definitions. However, Sustainable Fitch would also like to take this opportunity to highlight a number of important differences that exist between ESG ratings and credit ratings as we believe that such differences will be relevant when considering any specific rules or conditions that may be applicable to ESG rating providers operating within Australia.

IOSCO Code of Conduct

In addition to the general obligations applicable to financial service licensees (as per 912A of the Corporations Act), Sustainable Fitch understands that credit rating agencies operating in Australia are subject to additional licence conditions, including mandatory compliance with the IOSCO Code of Conduct Fundamentals for Credit Ratings Agencies.

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Sustainable Fitch

Sustainable Fitch highlights that no corresponding IOSCO Code of Conduct Fundamentals currently exists in relation to providers of ESG ratings. While IOSCO's recommendations for ESG rating providers[1] would provide a useful basis for making specific rules, Sustainable Fitch believes that they could not be directly applied as rules to ESG rating providers given that they are drafted as a set of recommendations.

Users of ESG ratings

Different ESG rating providers have various business models: user-pays, issuer-pays and hybrid models. These models may involve the provision of ESG ratings to the public as a whole, such as the publication of ratings on the provider's freely available website. In general, Sustainable Fitch does not consider that persons who access ratings freely and without a contractual arrangement should be considered users for the purposes of ESG rating regulation.

In addition, in the context of the Corporations Act 2001, to the extent that ESG ratings were to be regulated as financial services comparable to credit ratings, should Sustainable Fitch seek a licence, we anticipate that it would be a licence to provide services to wholesale clients but not to retail clients. Retail clients are not the target of Sustainable Fitch's business model and Sustainable Fitch does not envisage providing ESG ratings to retail clients in Australia.

ESG rating methodologies

When considering the specific rules that may be applicable to ESG ratings, it is important to consider that the methodologies used as the basis to determine ESG ratings can have various approaches and assess a variety of ESG factors. The result is that ESG ratings do not have a specific event or trigger against which they can be tested. This feature of ESG ratings is different from credit ratings which consider vulnerability to a specific event (default) and lend themselves to validation through transition and default studies.

Notably, there are many different use-cases for ESG ratings, with some users needing to assess ESG impact and others requiring ratings that focus on exposure to ESG risks. Similarly, some users will want a rating on an absolute scale to compare across sectors, while others will prefer a relative scale that enables greater distinction between companies operating in the same sector. Regulating the content or approach of methodologies would limit the ability of ESG rating providers to meet all of these needs. This limitation would be clearly negative for users, who appreciate a multiplicity of views to choose from – provided that the ESG providers are clear as to what an ESG rating represents.

[1] https://www.iosco.org/library/pubdocs/pdf/IOSCOPD690.pdf

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As mentioned above, one area of focus of any regulation of ESG rating providers should therefore be on ensuring the ESG rating providers describe the methodologies they apply to derive their ratings, as well as what the ratings mean.

Developing Market

When considering the extent of specific rules that may be applicable to ESG ratings, it is important to consider that the ESG rating landscape comprises numerous small-scale providers, a unique characteristic that necessitates careful consideration within the development of a regulatory framework. Alternative approaches to ESG ratings must have room to grow within the evolving regulatory framework, encouraging creativity and competition to benefit the market as a whole.

The ESG ratings market, despite its growing importance, remains in its infancy. It comprises a mix of established players and emerging companies. It is crucial that proportionality remains a guiding principle for all aspects of any proposed regulations, ensuring that the market can thrive while contributing to the Government's broader sustainability goals.

Smaller ESG rating providers may struggle to comply with regulatory demands, leading to their closure or market consolidation. With disproportionate regulatory requirements, new entrants to the market could be deterred, limiting the potential for innovation and competition. Thus, striking a balance is vital to cater to the diverse needs of investors and to support the Government's Sustainable Finance Strategy.

Comparable regulator exemption

In light of concurrent international proposals for the regulation of ESG rating providers (e.g., those being put forward in the EU[2] and the UK[3]), Sustainable Fitch believes that the parallel proposals of the Government to provide Australian financial service licensing exemptions to certain foreign financial services providers[4], in particular the proposed *comparable regulator exemption* regime, are relevant to the debate around the potential regulation of ESG ratings provided to wholesale clients in Australia.

For example, the proposed *comparable regulator exemption* regime may provide an alternative mechanism for the Government to establish minimum standards for ESG ratings provided by overseas ESG ratings providers that provide ESG ratings to wholesale clients based in Australia.

Alternative Approach

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[2] https://ec.europa.eu/commission/presscorner/detail/en/ip_23_3192

[3] https://www.gov.uk/government/consultations/future-regulatory-regime-for-environmental-social-and-governance-esg-ratings-providers#:~:text=Consultation%20description&text=This%20consultation%20paper%20sets%20out,%40hmtreasury.gov.uk.

[4] https://treasury.gov.au/consultation/c2023-430917?auHash=6xHZyoP025QS_Asr4OIFiyWTz73AqfoD_RWW8FlmhSM

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In addition, Sustainable Fitch highlights that a number of countries have implemented, or are developing, voluntary codes of conduct for ESG rating providers (e.g., Japan, Singapore, UK). Sustainable Fitch believes that a voluntary 'comply or explain' code of conduct approach can serve to establish minimum standards for ESG ratings without the risk of unduly constraining the evolution of the nascent industry.

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Sustainable Fitch thanks the Government for the opportunity to provide its thoughts and recommendations with respect to the Consultation. Should you have any questions with regard to our submission, please do not hesitate to contact me (on +34 93 323 8408 or at carmen.munoz@sustainablefitch.com).

Kind regards,

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