The Geostrategic Stakes of Extra-Financial Rating

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Plan

Introduction

- Growing importance of sustainability
  - Increasing awareness of ESG issues and greater emphasis on sustainability in investors, businesses and regulators' decisions and practices
- Critical role of ESG rating
  - Crucial role in assessing the ESG performance of companies
- Evolution of the rating landscape
  - Increased concentration of actors, debates between European and North American visions
- Geostrategic challenges
  - Strategic convergence or divergence of regulatory standards and practices
  - Needs for harmonization and transparency

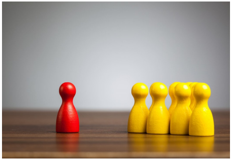
Identification of actors

Actors	Market share
MSCI (Morgan Stanly Capital International)	31%
Sustainalytics	10%
Moody's ESG Solutions	3%
S&P Global Inc. ESG Score	10%
ISS ESG	17%
CDP (Carbon Disclosure Project)	1%
Refinitiv	4%
LSEG	4%
RepRisk	2%
Other	15%
Source :	Opimas

The IHH index of the industry is 15 times higher than the purely and perfectly competitive index exhibiting a highly concentrated industry.

Concentration strategies

- Strategic acquisitions
  - MSCI acquisition of RiskMetrics Group in 2010
- Vertical expansion
  - Moody's ESG Solutions in 2019 by merging companies such as Vigeo Eiris and 427
- Strategic partnership
  - Sustainalytics and Morningstar in 2017 and Refinitiv in 2019
- New players
  - Technological startups such as Truvalue Labs, Datamaran, RepRisk (intensive use of big data and AI)



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The adverse economic consequences of market concentration of extra-financial CRA

- Reduced competition
  - Limiting choices for investors, issuers and other stakeholders.
  - Less innovation.
  - Lower quality ratings.
  - Higher costs for accessing rating services.
- Potential for Conflicts of Interests (Du Marais Frout08, Griffin and Tang 2011, Jiang et al. 2012, Kashyap and Kovrijnykh 2016, Beatty et al. 2019)
  - Pressures to prioritize the interests of the largest clients.
  - Pressures to maintain relationships to secure future business.
- Increased systemic risks (De Loecker, Eeckout and Unger 2020)
  - Mispricing of securities.
  - Market disruptions.
  - Contagion effects.
- Limited coverage and diverse pespectives
- Barriers to entry (oligopolistic competition)

The positive economic consequences of market concentration of extra-financial CRA

- Long-term concern about reputation reduce the temptation to issue favorable ratings (Bar-Isaac and Shapiro 2013, Dimitrov et al. 2015)
  - Because CRAs have a larger clientele to lose.
- Incentive to use stricter rating standards for keeping reputation (Hung, Kraft, Wang et al. 2022)
  - Increase in market shares correlated with stringency index.

Single v. Double Materiality

Single Materiality IASB definition

Information is material if omitting, misstating or obscuring it could reasonably be expected to influence decisions that the primary users of general purpose financial statements make on the basis of those financial statements, which provide financial information about a specific reporting entity.

- Information is considered material if its omission or misstatement could impact the decisions made by users of the financial statements.

Single v. Double Materiality

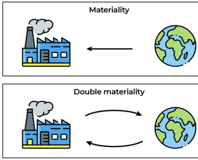
Double Materiality

Double materiality is a concept that extends the traditional understanding of materiality in accounting and reporting to consider not only the impacts of a company's activities on its own financial performance but also the broader environmental and social impacts of the company's operations on the economy, society, and the environment.

- This broader perspective acknowledges that a company's activities can have significant impacts beyond its financial performance, including environmental impacts (e.g. carbon emissions, water usage, pollution) and social impacts (e.g., labor practices, human rights, community relations).

Single v. Double Materiality

- The notion of materiality comes from the IASB in 2018 and is USA-oriented.
- In 2022, the European Union has issued a « directive »which renders the double materiality compulsory (CSRD).
- It is two notions of sustainable finance that are different (Laurence Scialom, 2023).
  - On the one hand, there are investors that want to know if their investment will preserve our planet.
  - On the other hand, there are investors that want to know the financial consequences of ecological degradation on the value of their investment.
- This debate reminds us about the notion of social cost with respect to private cost (Pigou).



Single v. Double Materiality

- We are witnessing a kind of war of standards.
  - The ISSB v. the EFRAG
  - International Sustainability Standards Board v. European Financial Reporting Advisory Group
- The European standards will become mandatory at the European level between 2025 and 2028 for European companies, depending on their size, but also for non-European firms above a certain threshold of activity carried out in Europe.
- Europe is thus introducing measures of extraterritoriality.

Single v. Double Materiality

- More precisely, the CSRD directive, which will come into effect as early as 2024, will not only concern foreign companies with a subsidiary established in Europe, but also, from 2028 onwards, those with a branch and those exceeding a certain level of activity in the EU.
- If these companies do not comply with the required disclosure requirements, they will face fines corresponding to a percentage of their annual turnover generated in the European Union.

Single v. Double Materiality

- In the US :
  - Fear from hidden protectionism.
  - Fear from the capacity to provide relevant estimates for companies.
  - Fear from a spread of the regulation within the US.
- In Europe :
  - To maintain the leadership whith respect to the standards : Increasing competition from China (compulsory extra-reporting for public companies in 2025).
  - Stop and Go - Backward (CS3D)
  - Creation of a comparative disadvantage and wild loopholes at the international level (NIMBY).

The quality of information

- The key element is the quality of information.
- This quality is a specific asset.
- Main features :
  - accuracy,
  - clarity,
  - relevance,
  - reliability,
  - timeliness,
  - accessibility,
  - objectivity,
  - transparency,
  - integrity,
  - utility.

The main references

- George Akerlof : Information asymetry
- Joseph Stiglitz : Economics of information
- Michael Spence : Information as a signal
- Kenneth Arrow : Contracts theory
- George Stigler : Regulation capture
- Elinor Ostrom : Common goods
- Herbert Simon : Limited rationality

- The main credit agencies are American.
- There are few European or international actors.
- Information control is a crucial issue.

ESRS Standards

- The European Commission has developed ESRS standards
- Environmental and Social Risks Screening standards
- These standards are designed to assist financial institutions in integrating environmental and social considerations into their decision-making process and promoting sustainable practices in their financing or investment activities.

Integration

- An ongoing debate in Europe concerns the willingness to internalize ESG ratings into mandatory accounting practices.
- That is to say, there is a question of entrusting the evaluation to accountants and auditors who will then incorporate it into mandatory accounting documents.
- This implies that there will no longer be a need for external evaluations such as those provided by rating agencies.
- Beyond economic efficiency, there is a call to the regulator to integrate a geostrategic dimension into decision-making.

Conclusion

- Thank you for your attention !