12th July 2021

To: Mairead McGuinness – EU Commissioner for Financial Stability, Financial Services, and the CMU
Paolo Gentiloni – EU Commissioner for Economy
Anneli Tuominen – Interim Chair, ESMA
John Berrigan – Director General, FISMA, European Commission
Kerstin Jorna – Director General, GROW, European Commission
Fabrizio Planta –Head of Markets and Data Reporting Department, ESMA
Marcel Haag – Director, Directorate B, FISMA, European Commission
Martin Spolc – Head of Unit, FISMA B.2, European Commission
Tanya Panova – Head of Unit, FISMA B.1, European Commission
Irene Tinagli – Chair of the ECON Committee, European Parliament

Daniele Franco – Minister for Economy and Finance, Italy
Alessandro Rivera – Director General, Treasury, Italy
Paolo Savona – Chairman, CONSOB, Italy
Stéphane Boujnah – Group CEO, Euronext

From: Davide Serra

CC: Davide Pelusi – CEO, Morningstar Italy

Dear Commissioner, Minister, Director General, Director, Head, Chairwoman, Chairman, CEO

Re: the concerning state of the ESG ratings industry

On 28th January 2021, ESMA (the "**Authority**") addressed a letter to the European Commission sharing the Authority's views on the main challenges in the area of environmental, social and governance ("**ESG**") ratings and assessment tools[1]. The Authority warned that the unregulated nature of the ESG ratings industry, when combined with increasing regulatory demands for consideration of ESG information, creates a risk of greenwashing, capital misallocation and product mis-selling.

Having recently experienced first-hand several of the issues highlighted by the Authority in its letter, we fully share their concerns. We are addressing this letter to you because we believe that by sharing our experience, we can provide further evidence in support of the Authority's view and its call for regulatory action on the ESG ratings industry.

Algebris is an independent global asset management firm specialised in the credit, debt and equity markets. One of our strategies invests primarily in small and mid-cap Italian equity securities. This strategy provides a source of funding diversification for accelerating organic and external growth in the Small and Medium Enterprises ("**SMEs**") that constitute the backbone of the Italian economic and industrial structure – a clear economic policy priority, as the Italian economy emerges from the COVID-19 shock.

[1] The letter can be found here: https://www.esma.europa.eu/sites/default/files/library/esma30-379-423_esma_letter_to_ec_on_esg_ratings.pdf

With a view to mobilize more investment towards this important market segment, Algebris recently made a request for this strategy to be onboarded by a major Italian distributor onto their distribution platform. This distributor then requested that the strategy obtain a Morningstar-issued ESG rating as a pre-condition to be onboarded onto the platform. We immediately contacted Morningstar in order to apply for an ESG rating, and Morningstar subsequently informed us that it could not assign an ESG rating to the strategy as more than 33% of the portfolio is invested in SMEs that are not assessed and scored by the ESG data provider Sustainalytics – coincidentally Sustainalytics is owned by Morningstar.

It was not surprising to learn that Sustainalytics opt not to cover a large share of the Italian SMEs within our portfolio. We are aware that ESG data providers typically only cover major market indices, and hence offer a low coverage of the small cap universe. One number suffices to demonstrate how relevant the size bias in ESG rating coverage is: we can map only 26%[2] of the Italian names within our strategy's portfolio to externally provided ESG scores[3] and the average market capitalization for the rated names is EUR 10.5bn, as opposed to an average market capitalisation of just EUR 300mn for the unrated names (mostly SMEs).

Conscious of this problem, the strategy investment team and Algebris ESG team carry out due diligence on the unrated companies through a detailed proprietary ESG questionnaire. Among the unrated SMEs in the portfolio are some truly innovative firms at the forefront of sustainability, such as *Reno de Medici* (European leader in the production of biodegradable cardboard from recycled materials), *Aton Green Storage* (Italian pioneer in the design and production of residential renewable energy storage systems), and *Seri Industrial* (a battery specialist and recipient of a EUR 505mn grant for the construction of the first giga-factory in Italy, in the context of the European Commission's IPCEI programme). None of these companies are rated by Sustainalytics[4], but they are pioneers in sustainable solutions and technologies.

Although we explained in detail this due diligence process (which we see as a core duty in our investment process irrespective of external ESG ratings) to Morningstar, they did not consider it relevant in deciding whether our strategy could be assigned a Morningstar ESG rating. Instead, the Morningstar team proposed we pay a fee for a Sustainalytics assessment of the unrated names that were missing towards the 67% coverage requirement. We were astounded to hear that Morningstar expected us to pay a fee for the (well-known) shortcomings of its own ESG data provider in covering the SMEs universe, but nonetheless we agreed to consider this proposal – only to be later told that it was no longer available.

We were informed that having received an unexpectedly high interest from other investors – presumably investing in SMEs and facing the same situation as ourselves – Morningstar feared that the *ad hoc* Sustainalytics assessment *they* were offering to SMEs investors as the only way to be considered for a Morningstar ESG rating would look like an operation of "rating on demand". We were hence told that while allowing for the possibility to request a paid-for evaluation of companies currently not covered by Sustainalytics, these companies would not be included in the calculation relevant to the attainment of the 67% requirement. As a result of this series of unfair and arbitrary decisions by Morningstar, we are left without an ESG rating and in turn little hope of expanding this small cap investment strategy in Italy.

This outcome has two important implications that investors and policymakers should carefully consider. Firstly, the current state of the ESG ratings industry risks creating an unfair bias in the allocation of capital. In order to be given the right, by the large platforms, to distribute investment funds, investment managers

[2] Calculated based on the unweighted number of names. Correcting for portfolio weights the figure would be 31%.
[3] Using ESG scores from third party provider S&P-Robeco SAM.
[4] Checked through the Sustainalytics ESG ratings search function here: https://www.sustainalytics.com/esg-ratings/

require an ESG rating for the strategy they aim to distribute. However, obtaining an ESG rating for a strategy that invests in SMEs is apparently impossible, because the main ESG data providers do not rate SMEs. This creates an incentive for investment managers to divert capital from SMEs (which typically have difficulty accessing non-bank funding) towards larger firms (which have no problem raising capital on the market). Rather than enable innovative and sustainability-focused SMEs to access a diversified pool of funding – a core objective of the EU Capital Market Union project – the current biased "tick-the-box" approach risks reinforcing the segmentation of the European capital market.

Secondly, and related to that, we are concerned that the disregard for well-known geographical market specificities by ESG ratings providers (the most important of which have recently all been bought by US rating agencies[5]) risks penalising investors in the European market compared to investors in the US market. Research shows that micro-employer enterprises are much more prevalent in the EU – and especially so in countries like Spain and Italy – while medium and large enterprises are more diffused in the US. While it is somewhat understandable that global firms like Morningstar require some level of standardisation in the rating methodology they apply across jurisdictions, we cannot but fear that the disregard for the different weight of SMEs in the industrial structure of different geographies, coupled with the lack of methodological flexibility described above, could result in penalising investors in the European market by making it relatively more difficult to access an ESG rating when investing in small caps. This would be particularly unfair at a time when access to private capital is desperately needed to build up the resilience of the European SMEs sector after the deepest recessionary shock in post-war history.

We urge regulators to act decisively on the issues facing the industry of ESG ratings. We second the Authority's call for a common definition of ESG ratings covering the broad spectrum of possible ESG assessments currently on offer, but with consideration for the idiosyncrasies of different geographical markets. The methodology currently applied by some of the dominant ESG ratings providers clearly disadvantages investors who focus on SMEs, and risks driving an inefficient and perverse capital allocation dynamic at the worst possible point in time. As investors, we welcome the increasing demand for assessments that provide insights on the ESG credentials of investment products, but we think it should go hand in hand with safeguards that ensure the information underpinning such ratings and assessments are robust, fair and reliable. Currently this is not the case, as our experience clearly demonstrates.

We look forward to your response and we remain at your disposal for any further discussion.

Yours sincerely,

Davide Serra
Algebris Investments
Founder & CEO

[5] Sustainalytics was acquired by Morningstar in April 2020. Moody's Corporation acquired a majority stake in Vigeo Eiris in April 2019. RobecoSAM has been acquired by S&P in November 2019.

About Algebris: Algebris is an independent, global asset management company embracing long-only, hedged and private debt investment strategies. Algebris has predominantly invested in the global financial sector, and over time gradually expanded its investment expertise beyond financials and currently covers six lines of business in terms of themes. Algebris is a signatory of UN PRI, and committed as a firm to achieve carbon neutrality. We are supporters of the Task Force on Climate-related Financial Disclosures (TCFD) and an investor signatory to the Carbon Disclosure Project (CDP). In 2020, we joined the Say on Climate Initiative, supported by the Children's Investment Fund Foundation, CDP and ShareAction. The initiative stems from a recognition that companies and investors are failing to address climate change, and that there is a growing need for companies to publish climate transition action plans. Only 2.5% of companies have committed to set a Science-Based Target and fewer than 100 companies globally address their shareholders on climate change issues each year, largely ad hoc. We believe that publishing climate transition action plans must become the norm for all listed companies, on an annual basis. As members of the initiative, we commit to enter into dialogue with investee companies and encourage them to submit a Climate Transition Action Plan at their AGM for a shareholder vote. Where companies will not do so voluntarily, we commit to vote for or file AGM resolutions requiring such votes. This commitment has been formally embedded into our firm-level voting policy. In 2021 we joined the Net Zero Asset Managers Initiative – promoted by the Institutional Investors Group on Climate Change (IGCC). The Net Zero Asset Managers initiative is a group of international asset managers committed to supporting the goal of net zero greenhouse gas emissions by 2050 or sooner, in line with global efforts to limit warming to 1.5 degrees Celsius; and to supporting investing aligned with net zero emissions by 2050 or sooner.