Response to ESMA Call for Evidence on ESG Ratings

11 March 2022

The Association for Financial Markets in Europe (AFME) and the International Swaps and Derivatives Association (ISDA), (together the "Associations") welcome the opportunity to respond to the ESMA Call for Evidence on Market Characteristics for ESG Rating Providers in the EU (the "Call for Evidence").

We are responding to several questions raised in the Call for Evidence from the perspective of our bank members as (1) users of ESG ratings and data; and (2) entities covered by ESG rating providers.

Introduction

The Associations welcome ESMA's Call for Evidence and the efforts by the EU and international authorities to examine the market for ESG ratings and ESG data. ESG ratings and ESG data perform an increasingly important role in capital markets and sustainable finance.

We hope that ESMA's review of the market will inform appropriate regulation of ESG ratings and data providers, applying the recommendations of the IOSCO report on ESG Ratings and Data Products Providers (the "IOSCO Report") as a common baseline. We encourage ESMA and the European Commission to continue to coordinate with their international counterparts to avoid a fragmented approach. This is particularly important given the global nature of the market for ESG ratings and data.

Questionnaire B for Users of ESG Rating Providers

Section 6.2.2 Use of ESG ratings

Q8. Please outline and explain any shortcomings in the ESG rating or ESG data products you currently contract for.

Given the increasing importance and relevance of ESG ratings and data in the markets and to support the financial sector's own risk management and disclosures, it is essential to ensure its transparency, comparability and reliability. While we appreciate that this is a developing area for ESG rating and data providers and that they are facing challenges regarding the availability of data from companies, our members have identified a number of shortcomings in ESG rating and data products that they currently use. These shortcomings are broadly aligned with the findings of the IOSCO Report.

A key concern relates to the need for greater transparency of methodologies. This is critical to enable users to understand what ESG ratings are measuring and what data the ratings are based upon. While we observe some improvement, particularly amongst larger providers, there remain significant shortcomings in this area. It is also critical that there is transparency regarding the data sources utilised by ESG ratings and data providers. We address this further in our answer to Question 9 below.

Feedback suggests that users do not necessarily understand exactly what an ESG rating is intended to measure. The challenge here is that different areas of the market and different use cases will merit different policy considerations and approaches. There are a broad range of products, services, and business models that make up the ESG ratings marketplace, as well as a variety of use cases for ESG ratings.

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As identified in the IOSCO Report and the European Commission's study on sustainability-related ratings, data and research, there is significant variation in ESG ratings due to different weightings of different ESG factors, leading to a low correlation of ESG scores from different providers for the same company. While there may be valid reasons for different ratings due to differences in focus, methodology and sources of data, there should be transparency of methodologies and data sources to facilitate comparability of ratings. Members generally observe a lack of alignment of definitions and approaches. This variability, combined with a lack of clarity on the methodologies used, makes ratings and data difficult to compare. There are also different approaches to data sources, with some providers using questionnaires and others controversy screening from media sources. For example, some ratings are absolute and others relative in a peer review comparison, limiting comparability of ratings. As proposed in the IOSCO Report, a common industry lexicon and/or disclosure template could help increase provider transparency on objectives, scope, methodologies and processes and would support greater clarity. ESG factors are more difficult to aggregate at a high level then credit ratings, which serve only one narrow purpose. Depending on an investor's/user's ESG strategy, different elements of the ESG equation might be important. An ESG rating, as such should at least be broken down to three sub ratings E, S and G.

Other shortcomings identified by users include the lack of coverage of ESG ratings and data products, as well as the need to ensure that providers have sufficient resources and analysts have sufficient expertise. A perceived lack of resources has led to use of over-simplified tools with little human analysis which is likely to be particularly necessary for complex industries. Resourcing should also be commensurate with the number of companies rated. ESG rating providers should ensure that the quality of the information provided to the market and investors is not compromised by the number of companies rated and by increasing number of requests coming from their clients and rated corporates. Transparency over sources of data should enable users to assess the degree of analysis in the rating.

Finally, users highlight issues with ESG rating providers' governance, for example that companies may not be aware that they are rated by certain ESG rating providers while others are not updated when there are changes to their rating, leading to asymmetry of information and inaccuracies in the reports. The escalation process to report inaccuracies with unsolicited ESG ratings is frequently very slow and time consuming for rated corporates, and in some cases may imply obtaining a solicited (fee paying) ESG rating, which means that reports that are be available to investors might not be corrected or updated for many months.

Q9. Please outline whether you are satisfied with the level of methodological transparency for the products you contract for, including transparency around data sourcing.

While we have observed some improvement in ESG ratings providers, offering greater transparency regarding their methodologies to different degrees, methodological transparency remains a key concern for members as users of ESG ratings. Transparency of methodologies is essential to enable users to understand what ESG ratings/scores are measuring and the drivers behind scores, enabling ratings to be compared effectively. There is little clarity and alignment on definitions, including on what ratings or data products intend to measure, i.e. whether they are measuring (i) risk for the company, (ii) risk for society and / or the environment or (iii) positive impact.

It is also critical that there is transparency regarding the data sources utilised by ESG ratings and data providers and this remains a concern. In some cases there is limited transparency provided regarding where data has been obtained from (including whether it comes from the rated company or a third party), the date of the information used in the analysis (latest financial / sustainability annual report vs previous reports) and how some of the business and geographical splits are derived.

However, it is important to note that future regulatory requirements focus on actual ESG ratings and their transparency and conflict of interest policies, in addition to enhanced ESG disclosures under CSRD, but do not create confusion with respect to input factors (ESG ratings and raw ESG data) and ESG products. For example, ESG index products are regulated under the EU BMR. Currently, market participants who are producing ESG ratings and ESG index products are applying conflict of interest policies to ensure independence and transparency of their products. Therefore, the EU should follow the IOSCO recommendations on ESG ratings which do not cover ESG index products. In general, any future regulation should take into account the difference between ESG ratings, scores and indices whilst avoiding duplicative or overlapping requirements across the overarching sustainable finance related regulatory framework.

Q11. Please outline and explain any shortcomings in the ESG rating or ESG data products you are currently using on a non-contractual basis.

Please see our response to Question 8, which also applies to ESG rating and data products provided on a non-contractual basis.

Q12. Please outline whether you are satisfied with the level of methodological transparency for the products [you] are currently using on a non-contractual basis.

Please see our response to Question 9, which also applies to ESG rating and data products provided on a non-contractual basis.

Section 6.2.3 Contractual characteristics

Our members have highlighted concerns regarding limitations which are often imposed by the provider on their ability to reference the provider's information in communications with their clients and their ability to use purchased data as an input to internal risk rating processes (e.g. climate risk assessments). Some providers are also limiting the permitted uses for ESG ratings.

We also observe a recent increase in the cost of the services and expect that this trend will be exacerbated by the fact that the market will need increasingly to use data to comply with regulatory requirements and to meet firms' climate commitments. In this regard we suggest that a principle should be established requiring fair and transparent commercial practices as exists for credit ratings. This principle should not only apply to ESG ratings, but also to ESG data provision.

Section 6.2.4 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 relevance of ESG ratings in financial markets has increased significantly over the last few years and is expected to continue to increase in relevance over the coming years. The increase in focus on ESG factors amongst investors, the increase in commitments by issuers and the increase in the application of ESG regulatory and disclosure requirements all drive the importance of ESG ratings in EU financial markets. ESG ratings are therefore very relevant to the EU financial market and market participants. This is because they provide a means of assessing investments from a perspective which presents both risk management and upside opportunities.

For example, some investors have certain minimum thresholds for issuers to meet to be maintained in their portfolios, while certain ESG passive funds follow ESG indices which rely heavily on ESG ratings and/or negative screens from the same ESG rating providers. ESG ratings therefore have increasing importance for issuers, potentially impacting their access to financing and pricing.

In addition to ESG ratings, we expect ESG data provision to become more important as the market will require increasing volumes of data to meet regulatory requirements including, for example, reporting the Green Asset Ratio under Article 8 of the EU Taxonomy Regulation, to assess climate risk for the purposes of risk management, and to integrate environmental and social objectives into business planning. While the eventual implementation of the Corporate Sustainability Reporting Directive (CSRD) may help address this, disclosures under the CSRD are not expected to be available for a few years. However, we note that ESG ratings and ESG data are different and that issues around appropriate disclosure regulation, and market practice, should not be conflated between the two.

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.

While we do not see ESG ratings as currently posing a major risk to financial stability, as discussed above, ESG ratings play an increasingly important role in EU financial markets. It is therefore important that the market has confidence in the quality and reliability of ESG ratings and that there is appropriate transparency, comparability and reliability of ESG ratings. Investors that use an ESG rating as an input for capital allocation should have reliable and transparent information about the basis for that rating. A lack of transparency and reliability could harm investor protection and an orderly functioning of the market.

Changes in ESG ratings are impacting pricing of securities. For many investors, ESG mandates are either directly tied to such third-party ratings (e.g. minimum thresholds or positive/negative screening) or heavily rely on them as inputs to their in-house ESG assessment frameworks and processes. Beyond investment research, decision making and portfolio construction, third-party ESG ratings are increasingly being used to structure ESG financial services and products.

The sustainability-linked instrument space is also making use of third-party ESG ratings. It is not so common with bonds, but sustainability-linked loans are often tied to a third-party provider's ESG rating of a company and the interest rate margin can ratchet up and down depending on whether a rating improves or deteriorates. This could give rise to risks if a company's interest rate costs could be linked to ESG ratings.

We welcome ESMA's review of the market and the European Commission considering how to ensure this and support reflecting upon the recommendations of the IOSCO Report as a common baseline. We encourage ESMA and the European Commission to continue to coordinate with their international counterparts to avoid a fragmented approach. This is particularly important given the global nature of the market for ESG ratings and data.

We also welcome the work underway to improve corporate sustainability disclosures, which should improve the availability and quality of ESG data. This should in turn enhance the reliability of ESG ratings and data, but note that this will take some time to put in place, particularly outside Europe and there will be a continued need for the use of ESG ratings and data.

As identified in the IOSCO Report, there could be a risk of conflicts of interests arising which need to be appropriately addressed. For example, some issuers with unsolicited ratings face having to pay for a solicited rating if they wish to update or correct an unsolicited rating.

Many of the major ESG Rating Providers also offer second party opinion services. It should be noted that ratings sometimes feed into these opinions and this can be unhelpful to the issuer in light of the limited opportunity to provide input into the ratings process as discussed further below.

Questionnaire C for Entities Covered by ESG Rating Providers

Section 6.3.2 Interactions with ESG rating providers

General comments - governance

In light of the importance of ESG ratings and data for issuers as discussed above, it is essential that the process for interactions between ESG Rating Providers and covered entities is effective to support the reliability of the ratings. More systematic and effective engagement between ESG rating providers and rated companies would improve the reliability of ratings and the orderly functioning of the market. Unlike credit ratings, ESG ratings are usually – but not always - unsolicited and there can often be very little interaction between score providers and companies. In this case, data is frequently collected from public sources including company reports and, for controversy screening, from the media. These sources may be inaccurate and, if taken out of context, conclusions based on information collected from the media may be misleading and/or outdated. For financial institutions in particular, feedback suggests an overreliance on controversy screening from public sources. Instead, providers should be obtaining information directly by engaging with the rated companies.

Companies may not be aware that they are rated by certain ESG Rating Providers while others are not updated when there are changes to their rating, leading to asymmetry of information and inaccuracies in the reports.

Rated companies should be given notice of unsolicited ratings being prepared or existing ratings being updated, while being offered sufficient time to provide precise data and relevant, contextual information. Ratings should then be reviewed and updated regularly and with similar levels of engagement. It would be beneficial for rated entities to be provided with advance notice of the timing of reviews to facilitate efficient engagement. Rated entities should also be informed of rating changes, preferably in advance with analysts made available to discuss reports. To facilitate this, an exemption should be provided enabling delayed disclosure of rating changes where this is price sensitive information for the purposes of the Market Abuse Regulation.

The process for making changes to ESG rating methodologies should also be improved. ESG Rating Providers should be transparent regarding changes to their methodology and consult the market on changes to methodologies. While some providers have increased transparency, this remains mixed.

As indicated above, members find that providers do not always have sufficient resources to cope with the breadth of coverage and that analysts often lack the necessary ESG expertise. Addressing this lack of resources can significantly improve the quality of interactions with ESG rating providers and, in turn, of ESG ratings and data.

Q3: Please outline whether your company is provided opportunities to correct any error relating to the ESG rating provided for your company, and if so, how this is performed and at what stage of the rating

Some, but not all, providers do provide processes to report inaccuracies in ESG ratings. However, feedback suggests that the escalation process to report inaccuracies with unsolicited ESG ratings is frequently very slow and time consuming for rated corporates, and in some cases may imply obtaining a solicited (fee paying) ESG rating, which means that reports that are be available to investors might not be corrected or updated for many months.

Section 6.3.3 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.

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.

Please refer to our answers to Questions 1 and 2 under section 6.2.4 above.

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About AFME

AFME represents a broad array of European and global participants in the wholesale financial markets. Its members comprise pan-EU and global banks as well as key regional banks, brokers, law firms, investors and other financial market participants. We advocate stable, competitive, sustainable European financial markets that support economic growth and benefit society.[1]

[1] AFME is the European member of the Global Financial Markets Association (GFMA) a global alliance with the Securities Industry and Financial Markets Association (SIFMA) in the US, and the Asia Securities Industry and Financial Markets Association (ASIFMA) in Asia. AFME is registered on the EU Transparency Register, registration number 65110063986-76.

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Since 1985, ISDA has worked to make the global derivatives markets safer and more efficient. Today, ISDA has over 970 member institutions from 77 countries. These members comprise a broad range of derivatives market participants, including corporations, investment managers, government and supranational entities, insurance companies, energy and commodities firms, and international and regional banks. In addition to market participants, members also include key components of the derivatives market infrastructure, such as exchanges, intermediaries, clearing houses and repositories, as well as law firms, accounting firms and other service providers. Information about ISDA and its activities is available on the Association's website: www.isda.org. Follow us on Twitter, LinkedIn, Facebook and YouTube.