

March 11, 2022

Via electronic mail

European Securities and Markets Authority (ESMA)
201-203 Rue de Bercy
75012 Paris
France



Re: IIF Response to ESMA Call for Evidence on Market Characteristics for ESG Ratings Providers in the EU

Dear Ms. Ross, Mr. Thedéen, and Ms. Cazenave,

The Institute of International Finance (IIF) and its members, which broadly represent the global financial services industry, appreciate the opportunity to provide public comments to the European Securities and Markets Authority (ESMA) on its *Call for Evidence on Market Characteristics for ESG Ratings Providers in the EU* (hereafter “the Call for Evidence”).¹ The IIF is the global association of the financial industry, with more than 400 members from approximately 70 countries, including commercial and investment banks, asset managers, insurance companies, ratings agencies, market infrastructure providers, and professional services firms.

Reflecting the global, cross-sectoral nature of the IIF’s membership, this letter provides **international perspectives on the market for ESG ratings in the EU, and high-level views on the significance of ESG ratings for both EU and non-EU domiciled financial institutions.** Overarching comments can be found in section 1, and we address the first two questions of the Call for Evidence (sections 2 and 3) with industry views on potential market-based and regulatory approaches to help strengthen the robustness of ESG ratings, while also enabling innovation. Finally, this letter sets out key considerations for potential future interventions by ESMA or the European Commission (EC) (section 4). Reflecting our call for greater alignment in sustainable finance policy and regulatory frameworks across markets, this letter draws upon our new report shared with you in February: **“Integrity Through Alignment: A 2022 Roadmap for Global Standards and Market-led Approaches in Sustainable Finance.”**²

1. Overarching comments

As a global association, the IIF recognizes that maintaining integrity in sustainable finance markets requires strong foundations in the form of high-quality, verifiable, and reliable ESG data, including ESG ratings. While third-party ESG data products and ESG ratings are potentially a very useful additional source of information, both public and private sector stakeholders note challenges with the scope, coverage, clarity and transparency of ESG data and ratings, including difficulty in discerning the quality and suitability of some of these products.³

The increasing significance of ESG ratings and data products for financial market decision-making has raised important questions about whether providers should be subject to some degree of

¹ <https://www.esma.europa.eu/press-news/esma-news/esma-launches-call-evidence-esg-ratings>.

² IIF 2022, “[Integrity Through Alignment: A 2022 Roadmap for Global Standards and Market-led Approaches in Sustainable Finance](#)” (February).

³ See discussion in IIF response to IOSCO consultation: IIF 2021, “[IIF response to IOSCO Consultation on ESG Ratings and Data Products Providers](#)” (September).

oversight. While market-based standards and practices are continuing to develop, securities and markets regulators in the EU and some other jurisdictions have also been exploring potential supervisory and regulatory interventions.⁴ **Recognizing that many providers of ESG ratings are global in nature, and that cross-border financial firms active in the EU are applying these products in a variety of ways, developing globally consistent supervisory and regulatory frameworks should be a key objective, and it is important to consider that developments in one jurisdiction can have cross-jurisdictional implications.**

Towards this end, we **would strongly recommend that any potential action by ESMA in response to the findings of the Call for Evidence reflect the final International Organization of Securities Commissions' (IOSCO) recommendations on ESG ratings and data products issued in late 2021,**⁵ which provide a helpful foundation to support the development of a robust, transparent, innovative and high-integrity market for ESG ratings globally .

2. Relevance of ESG ratings to EU financial markets and financial market participants

Financial institutions rely on ESG ratings and data products for many purposes, including as inputs to risk management activities, capital allocation decisions, product development and disclosure. Across different uses, there are important differences between ESG ratings and other ESG data products, including for client and counterparty risk assessment. **The IIF supports ESMA's application of IOSCO's definitions for ESG ratings and data products providers, and would encourage ESMA to call attention to the important differences between these two types of products.** This letter focuses mainly on ESG ratings, reflecting the scope of the Call for Evidence; however, we would encourage ESMA to analyze how actions in the ESG ratings space may be relevant to providers of other ESG data products, considering the increasingly significant role that these products are likely to play in the future.

The market for ESG ratings in the EU is extremely diverse, and developing rapidly - yet gaps remain in terms of the scope, coverage, and transparency of ESG ratings, which pose challenges for financial institutions. Different ESG ratings providers offer a range of products, with varying levels of granularity. Some ESG ratings providers also provide other services, including advisory services or solutions focused on individual environmental, social, or governance factors, such as climate risks.⁶ Providers use different and often proprietary methods of categorizing ESG performance information, consider different types of data on specific risks or opportunities that may affect performance of covered entities, apply different approaches to gathering and transforming data when constructing ratings, and exhibit important differences in their definitions of materiality (for example, whether they are estimating ESG risks to an organization or the sustainability impact of that organization). Moreover, ESG ratings providers may distinguish themselves by specializing in particular regions, sectors and asset classes.⁷

From the perspective of users of ESG ratings,⁸ financial firms perceive the following challenges:

⁴ See UK Financial Conduct Authority (2021), "[Our ESG Priorities](#)"; Securities and Exchange Board of India (SEBI) 2022, "[Consultation Paper on Environmental, Social and Governance \(ESG\) Rating Providers for Securities Markets](#)" (January).

⁵ IOSCO 2021 <https://www.iosco.org/library/pubdocs/pdf/IOSCOPD690.pdf>

⁶ For a helpful overview of different providers offerings, please see IRSG 2022 "[ESG Ratings and ESG Data in Financial Services](#)".

⁷ IIF 2020. "[IIF Green Weekly Insight Charting Course: Mapping ESG Data Providers](#)" (July 9).

⁸ This response uses the terms 'providers', 'users' and 'covered entities' throughout, reflecting the terms used by IOSCO in its 2021 Principles.

- i) **Clarity regarding what a rating is intended to measure** (e.g., ESG performance, potential ESG-related risks to a covered entity, or sustainability impacts from corporate operations);
- ii) **Transparency** regarding the underlying construction of ESG ratings products, including data inputs, methodologies, and processes;
- iii) **Difficulty in discerning product quality and suitability** given the above-mentioned lack of clarity and transparency;
- iv) **High cost of services and concerns regarding market power of providers**, due to increasing reliance of users of such products in order to respond to new regulatory frameworks and stakeholder expectations.

From the perspective of covered entities, financial firms perceive the following challenges:

- v) **Low levels of engagement with financial firms** as covered entities;
- vi) **Highly resource intensive response processes** to satisfy data requests of multiple providers;
- vii) **Opacity around the factors affecting final ESG ratings** of covered entities;
- viii) **Potential conflicts of interest** where boundaries between ratings and consultancy functions are not always clearly delineated.

Clarity on what different ratings are intended to measure and capture is extremely important and not always clearly articulated. It would be beneficial for providers of ESG ratings or scorings to make a clear statement about what exactly they are assessing, and over what time horizon.⁹ For example, it is not always clear whether a rating or score is intended to measure ESG risk to an organization or the sustainability impact of that organization. While ESG risk and sustainability impact can be related, they are different measures that should not be conflated. ESG risk, sometimes referred to as ‘financial materiality’, measures the risk that ESG factors pose to the performance of an organization. Sustainability impact, often referred to as ‘double materiality’ when considered in addition to financial materiality, measures the impact of an organization on the environment and society. While sustainability impacts may present ESG risks, the two measures are not one and the same. Without such clarity, ESG ratings and data products that are sustainability impact oriented may be inappropriately used to measure ESG risk. This can be particularly problematic in the context of integrating ESG ratings or data into credit ratings, where ESG risk should be approached through the same lens and with the same rigor as existing credit rating agency processes. It is, therefore, essential that Providers offer clarity and transparency on what different ratings and data products are intended to measure.

Greater transparency regarding the inputs to ESG ratings, standardization in data collection process, and harmonization of data sources and methodologies, could enable users to interpret them appropriately and discern product quality and suitability. It would be useful to distinguish and clarify the criteria, methodologies and assumptions used for issuing ESG ratings, scorings or rankings. Methodologies underlying ESG ratings are based on numerous choices, judgements, assumptions (including weightings) and proxies, which are in most cases not disclosed by providers. For example, some providers calculate a covered entity’s rating based on an assessment relative to a covered entity’s peers. This element of the rating is generally not transparent, which can make it hard to judge how well it reflects a covered entity’s ESG risk management. If lack of transparency results in a rating that cannot be readily replicated (even with a full data set), this can create the perception of a “black box” approach. This in turn can make it hard for users and covered entities to easily understand the drivers of differing ESG ratings or data

⁹ Although different, providers of credit ratings clearly state what the rating represents; for example, near-term or long-term probability of default, or timeliness of payment and willingness to pay a credit obligation.

points between entities (or for the same entity), which can vary for a number of legitimate reasons. Moreover, without transparency, providers may not have accountability for methodological or data errors, stale ratings or data, or other issues. While providers have a legitimate interest in avoiding disclosing commercially sensitive information (including proprietary methodologies), these interests must be balanced with users' and covered entities' need for greater transparency.

Over-concentration in the ESG ratings market could lead to excessive market power of providers, which could further increase costs. The broad coverage of ESG assessment and the resource-intensive and expert nature of sustainability research and ratings are all factors contributing to strong concentration in this market. Considering the increase of the ESG data needs, and the timeline for the implementation of economy-wide ESG reporting standards in the EU, financial institutions are already observing an increase in the costs of services associated with ESG ratings. **As such, we would encourage ESMA and the EC to consider the need for guidelines regarding fair and transparent commercial practices in this area,** considering the potential impact that ESG products can ultimately have on portfolio allocation and real economy outcomes.

The EU legislative proposal for a European Single Access Point (ESAP) is highly appreciated and could helpfully reduce information asymmetries between covered entities, providers, and users. The ESAP might also be helpful in order to be able to better understand ratings (if ESG ratings are based on the data available in ESAP); thus, a certain level of quality control could be possible in the market.

Enhanced engagement between ESG ratings providers with covered entities could enhance the accuracy and reliability of an entities' rating. Covered entities could be better involved in the ESG ratings process, and have the right to review the end results before they are communicated to investors to avoid any misinterpretations from data providers of information conveyed by covered entities. Although financial institutions have observed some progress in the past year in engagements with ESG rating agencies, there are still several challenges to be addressed from a covered entity's perspective, notably:

- There is still a lack of engagement with covered entities on disclosed data, and dialogue on methodologies applied in ratings construction. Some agencies still do not provide one dedicated analyst per covered entity, leading to potential issues regarding appropriate levels of internal due diligence and oversight of data issues, which can potentially result in inaccurate conclusions.
- Methodologies may be very rigid following an over-simplistic "tick the box" approach for companies in comparable sectors, which can constrain analysis or interpretation of issues that may be unique to a firm's ESG characteristics.
- Controversies, which tend to be backward-looking, can have a significant weighting within a firm's overall ratings with only minor weighting applied for remedial measures. As such, these factors may weigh on a company rating for up to five years, even after settlement. Furthermore, this analysis is often focused on media sources and communications by external stakeholders, rather than on company disclosures, and may not reflect any legal understanding of the controversy in question, which can lead to incorrect interpretation.

Finally, more consideration should be given to **how to expand the scope of companies that are ESG-assessed**; for example, increasing coverage of smaller and non-listed firms and those from emerging and developing markets. Public-private dialogue on this topic could be beneficial.

3. Potential risks ESG ratings may pose to orderly markets, financial stability, and investor protection in the EU

There are no specific indications at present that ESG ratings pose major risks to orderly financial markets or financial stability. However, considering the increasing importance of the role of ESG ratings, a lack of reliability and transparency in ESG ratings could potentially pose risks in future to financial markets under certain circumstances.

With respect to goals of ensuring orderly markets, **industry stakeholders broadly agree that the market for ESG ratings needs to become more mature and transparent to ensure the highest standards of integrity, to enable appropriate interpretation and use of the products and services provided, and to expand to cover a wider range of assessed companies.** This objective is most likely to be successfully achieved through a combination of market-based and public policy actions. For example, market-led development of a set of industry standards and codes of conduct for the ESG ratings and data products marketplace could be an effective way to drive coherence over time, supporting market development and maturity. This type of market-based action would ideally be built on clear requirements for minimum standards around quality assurance, governance, conflict of interest management, fair and transparent commercial practices and transparency on methodologies and data sources across jurisdictions, in line with the 2021 IOSCO recommendations.

With respect to financial stability, **industry stakeholders do not consider that the current market structures for ESG ratings – and the way they are used by financial institutions – are likely to pose risks to financial stability.** Financial institutions generally use ESG ratings cautiously, alongside other data inputs as part of internal decision-making on risk assessment and credit allocation. However, under certain circumstances, over-reliance on poor-quality ESG ratings by financial institutions in portfolio construction or other capital allocation decisions could potentially exacerbate existing vulnerabilities in certain financial market segments (e.g., if a rating leads to a misinterpretation of risks for a particular security, this could potentially contribute to development of a “green bubble”, a risk of greenwashing or – in the opposite direction – reduced flow of transition finance to certain sectors). **Our members broadly agree that the many legislative initiatives underway in the EU aiming to align financial market practices with sustainability objectives have “increased financial market participants’ needs for information on entities’ sustainability characteristics”,**¹⁰ resulting in an increasing need to refer to third-party ESG data products, including ratings. As such, this may warrant ongoing monitoring and efforts to improve transparency and standardization as well as better governance and engagement with covered entities.

With respect to investor protection, **industry stakeholders believe that risks to investor protection stemming from the use of ESG ratings are currently low.** However, public debate on the risk of real or perceived greenwashing has raised important questions about the use of ESG ratings or other products (e.g., benchmarks). The objectives of frameworks for classification of retail investment products (e.g., under the EU’s Sustainable Finance Disclosure Regulation, SFDR), which set a high bar for financial institutions’ compliance, could potentially be impeded if underlying ESG ratings used to inform portfolio construction of such products cannot be considered entirely reliable.

More broadly, **it is important for securities regulators and prudential authorities to have a strong understanding of the uses and limitations of ESG ratings and specific data products**

¹⁰ Call for Evidence, page 6.

before applying regulation or supervisory expectations that require the use of ESG ratings and data (either directly or indirectly) – e.g., in disclosure, product construction, risk management and scenario analysis expectations. It may be worthwhile for ESMA to reflect on **the degree to which the design and implementation of various EU-level sustainable finance policy measures may further increase the reliance of financial market participants on ESG ratings**, especially in the absence of other data sources on clients and counterparties.

Looking forward, it will be important to monitor whether risks to markets, financial stability or investor protection could in future arise from the activities of ESG ratings providers (e.g., a lack of transparency), the application of ratings by firms individually or at system levels (e.g., potential for ESG ratings to exacerbate herding behavior), or other factors affecting the need for firms to rely on such ratings (e.g., regulatory and supervisory requirements).

4. Considerations for next steps by ESMA and the EC

Given the early stage of maturity and evolving market practices in the EU and globally, there is a strong case for allowing the ESG ratings industry to become more mature and transparent in a market-led way, supported by regulatory safeguards in areas such as transparency, governance, engagement with covered entities, and fair and transparent commercial practices. There is broad acceptance that the ESG data and product market is at an early stage of development and will take time to mature, as it has already started to do with a round of consolidations.¹¹ Some providers are voluntarily taking steps to increase transparency around their products and services,¹² and some credit rating agencies are increasingly publishing information about how ESG factors influence ratings actions.¹³ However, it may be necessary to accelerate the maturity process considering the importance of those providers in the near term.

Looking forward, it would be helpful for ESMA to clarify in what ways its supervisory mandate could potentially extend to ESG ratings providers, including through its existing supervisory relationships. As pointed out in the Call for Evidence, *“ESMA’s supervisory mandate does not currently extend to ESG rating providers, ESMA does have existing supervisory relationships with entities affiliated with ESG rating providers through their wider group structure.”*¹⁴ Clarifying this, and how any potential future interventions would relate to providers of ESG ratings vs. providers of credit ratings, is extremely important to avoid market distortions. For example, if entities that are part of group structures overseen by ESMA were subject to specific interventions while other ESG ratings providers were not, this could cause an unlevel playing field.

Global consistency on the policy and regulatory approaches to ESG ratings is highly desirable; as such, we would highlight the need for any potential actions by ESMA or the EC to be aligned with IOSCO’s 2021 recommendations. We recognize that the EC is likely to launch a complementary consultation to gather stakeholder views about the use of ESG ratings by market participants and the functioning and dynamics of the market, with the aim of helping to gather information for an impact assessment on the costs and options of a possible intervention at EU level. We would encourage ESMA and the EC to engage with their international counterparts, including at the IOSCO level, to identify what options may exist to develop **global minimum**

¹¹ IOSCO 2021, *“Environmental, Social and Governance (ESG) Ratings and Data Products Providers: Final Report”* (November).

¹² For example, the company RepRisk now publishes their detailed methodology on their website. Responsible Investor 2021, *“RepRisk CEO says: ESG needs transparency – we have it”* (November).

¹³ See Moody’s (Moody’s Investors Service 2021, *“Moody’s updates its general principles for assessing environmental, social and governance risks methodology”* (press release, April); S&P (S&P Global Ratings 2021, *“General Criteria: Environmental, Social, and Governance Principles in Ratings”* (press release, October).

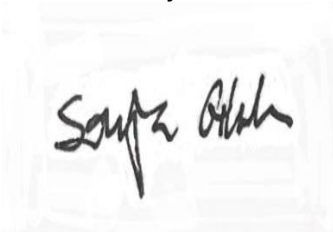
¹⁴ Call for Evidence, page 6.

transparency requirements for ESG ratings and data product providers – on issues such as definitions, data sources, methodologies, and processes – as improvements in transparency would help to mitigate many of the current challenges to a large extent.

Further work by EU-level entities should consider: i) the **role and relationship to existing sustainability regulations in the EU**, including existing indicators and metrics specified within EU-level instruments (e.g., SFDR, Taxonomy Regulation); ii) relevant **standardization initiatives at the global level**, including the efforts of the International Sustainability Standards Board (ISSB) to develop a global baseline ESG disclosure standard which could play a key role in ensuring that ESG ratings are, to some extent, based on globally comparable ESG information; and iii) the **possible effects of different rating approaches for EU vs. non-EU companies**, which may create an unlevel playing field.

Thank you for your consideration of these comments. On behalf of the IIF membership, we hope that these global industry perspectives will contribute to your efforts. We would be happy to discuss any of these matters further and invite you to contact Sonja Gibbs (sgibbs@iif.com) or Andres Portilla (aportilla@iif.com) should you have questions or comments.

Yours sincerely,



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