

Response to the consultation on the functioning of the ESG ratings market in the EU and the consideration of ESG factors in credit ratings

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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 European Commission’s targeted consultation on the functioning of the ESG ratings market in the European union and on the consideration of ESG factors in credit ratings. We elaborate on previous submissions to European [Commission](#), [IOSCO](#), and [ESMA](#).

As both the consultation and the Commission’s [study](#) recognise, we find that financial market participants increasingly rely on ESG ratings to complement their screening methodologies, risk management, and sustainability reporting. This is driven by investors’ demand for ESG products, increased awareness of the importance of ESG risk management, as well as regulatory requirements for financial services firms to produce sustainability disclosures despite challenges with the availability of disclosures by companies.

The market for ESG ratings, however, is not sufficiently mature yet and we have identified a series of shortcomings with the levels of concentration in the market, with the comparability of the ratings, and concerning the engagement between providers and rated companies:

- Users and investors struggle with a lack of clarity on the methodologies used by ESG ratings providers and understanding the purposes of different ESG rating products.
- Rated companies criticize the lack of appropriate channels to engage with providers to receive notice of ratings, provide contextual information, or report any inaccuracies.
- High levels of concentration in the market harm competitiveness, increase the likelihood for conflicts of interest to arise, and reduce choice for users.

EU intervention can address some of these shortcomings through a common, harmonised and enforceable framework for transparency and governance applicable to ESG ratings providers. Nevertheless, any intervention must ensure that the sector can continue to innovate and leave space to new entrants in the market. Measures should also be taken in coordination with other bodies considering intervention, such as IOSCO and the UK FCA.

We recommend that EU intervention prioritises the following actions:

- Improving transparency on the methodologies used by the ESG ratings providers through the introduction of minimum disclosure requirements.
- Improving the reliability and comparability of ratings by ensuring ESG ratings providers specify their sources of data and the intended uses of ESG rating products.
- Mitigating potential conflicts of interests by introducing minimum transparency requirements on ESG ratings providers’ policies and governance arrangements.
- Providing some supervision on the operations of these providers, expanding ESMA’s remit and establishing a registration and supervision regime for ESG ratings providers.
- Fostering better engagement between ESG ratings providers and rated companies to ensure there are appropriate channels to exchange information and report inaccuracies.

With respect to the incorporation of ESG factors in credit ratings, we do not identify a need for further EU intervention. The extent to which CRAs incorporate ESG factors in credit ratings depends on the asset classes methodologies and the importance assigned to the given factor by a CRA’s methodology. We observe that, in general, CRAs have sufficiently improved the incorporation of ESG factors in credit ratings, although some are lagging behind.

The remainder of this paper provides detailed response to the questions in the consultation.

PART A – ESG RATINGS

I. Use of ESG ratings and dynamics of the market

1. Questions for investors, asset managers and benchmark administrators

Do you use ESG ratings?

- Yes, very much
- Yes, a little
- No

Please explain

- Use of ESG ratings increased rapidly alongside investors' demand, offering of sustainable investment products, sustainability risks and opportunities, and sustainability-related regulatory pressure.
 - Uses include supporting the assessment of the ESG performance of companies, the related creation of different sustainable investment products or sustainability-linked bonds, loans, derivatives, guarantee facilities, hedging agreements, accounts receivables, supply chain finance, and to identify sustainability risks and opportunities in this context.
- The imperfect sequencing of sustainability disclosure requirements made financial institutions increasingly reliant on third-parties to obtain information and make estimations.
- ESG ratings only partially make up for the lack of publicly available information. In most case, ESG ratings complement banks' own datasets and assessment methodologies. Subscription to ESG rating services is often paired with the purchase of raw ESG data.

Which type of ESG ratings do you use?

ESG ratings providing an opinion on companies:

- ESG ratings providing an opinion on opportunities
- ESG ratings providing an opinion on the compliance of companies with frameworks and rules
- Exposure to and management of ESG risks
- ESG ratings providing an opinion on a company performance towards certain objectives
- ESG ratings providing an opinion on the impact of companies on the society and environment
- ESG ratings providing an opinion on the ESG profile of the company

ESG ratings providing an opinion on investment funds or other financial products (please specify which financial products):

- Investment funds
- Others (comment box)
- Exposure to and management of ESG risks
- Impact on the society and environment
- ESG characteristics
- Other specialised ratings

- None
- Not applicable

If you responded that you use specialised ratings, please indicate which one(s):

N/A

To what degree do you use ESG ratings in investment or other financing decisions on the a scale of from 1 to 10 (1- very little, 10 – decisive)?

5

Do you use overall ESG ratings or ratings of individual Environmental, Social or Governance factors?

- Overall ESG ratings
- Ratings of an individual Environmental, Social and Governance factors
- Ratings of specific elements within the Environmental, Social and Governance factors,
- Other types, please specify

Do you buy ESG ratings as a part of a larger package of services?

- Yes
- No
- Not applicable

If you responded yes to the previous question, what other services do you buy?

Packages of services may include ESG screening, company and fund ratings, controversy screenings, ESG data.

If you responded yes to the previous question, do you consider that buying ESG ratings as a part of a larger package would give rise to potential conflicts of interests?

Both the Commission's [study](#) and IOSCO's [report](#) correctly identify the potential conflicts of interest that may be caused by providers' increasingly broad range of services offered.

What are you using ESG ratings for? (multiple choice)

- as a starting point for internal analysis
- as one of many sources of information that influence the investment decisions
- to meet regulatory or reporting requirements
- as a decisive input into an investment decision
- as a reference in financial contracts and collaterals
- for risk management purposes
- other(s).

If you use ESG ratings for other purposes, please specify which ones?

ESG ratings are used to assess clients' sustainability strategies, to complement banks' internal analysis tools (including for due diligence purposes), and they can also be used as KPIs in sustainability-linked transactions. ESG ratings are also used for controversy screening and to assess counterparties' ESG risk.

Do you refer to ESG ratings in any public documents or materials?

- Yes
- No

If you responded yes to the previous question, specify the type of documents or materials

ESG ratings can be used when illustrating the process followed when issuing green/sustainability bonds, regarding the need to obtain a second-party opinion on adherence to market principles. It could also be used to determine pay-outs in the context of ESG-linked derivatives.

In the context of Sustainability-Linked Derivatives (SLDs), having an independent third party minimizes the risk of moral hazard and the potential for conflicts of interest to arise given the economic consequences of meeting or failing to meet sustainability KPIs. It may also minimize potential disputes. The involvement of a third party will be intrinsic where the KPI is linked to a counterparty's general ESG rating. This is because the counterparty will be deemed to have met the KPI if it is granted a specific rating by the ESG rating agency. In other cases, the third party will need to be specifically chosen and appointed by the counterparties. This third party may be (without limitation) an auditor, environmental consultant or expert in the particular subject matter of the KPI.

What do you value and need most in ESG ratings:

- transparency in data sourcing and methodologies.
- timeliness, accuracy and reliability of ESG ratings.
- final score of individual factors
- aggregated score of all factors
- rating report explaining the final score or aggregated score
- specific information, please explain
- data accompanying rating
- other aspects

If you responded 'other aspects' to the previous question, please explain why :

- While different providers' scores on the same company may diverge, transparency in data sourcing and methodologies is essential for users.
 - Users need clarity on what ESG ratings are measuring – whether it is ESG risk exposure, governance practices, level of disclosure, physical or transition risks, etc.
 - Where an individual ratings provider offers different types of reports, transparency in regards to the differing methodologies behind each report and the type of underlying data relied upon (e.g. public vs. private) is very important.
 - Where transparency is insufficient, users often choose to purchase raw data instead. Links and references to sources provided by ESG ratings are particularly valuable.

- Treatment of controversies and how they affect the final rating is usually not transparent enough.
- While regulatory requirements should be mindful of enhancing the transparency of methodologies, they should not interfere in the methodological freedom of rating providers, with a view to not stifling innovation in the field of ESG ratings.
- It is also important that a change to an ESG score is provided to all market participants in a consistent and transparent way. Where certain market participants are not aware of a change (or do not have access) to an ESG ratings' change, this can lead to distortion within the market.
- Timeliness, accuracy, and reliability of ESG ratings is also essential for a fair and effective market, especially when ratings are employed to help meeting regulatory requirements or for the provision of loans - and thus have an impact on the cost for companies to raise capital.
 - In addition to timeliness, the frequency of updates is a highly important factor.
- Users value forward-looking metrics and strategic considerations on rated companies' transition towards a sustainable business above backward-looking information. Users would also benefit from increased transparency on whether the data is backward looking or forward looking.
- A rating report explaining the final score or aggregated score provides invaluable contextual information for users to understand the purpose of each rating and identify the most relevant information and the most appropriate use for each rating.
- Due to the given complexity of adherence to ESG regulation, users will increasingly need information on companies' alignment to ESG regulation, for example the degree of alignment with the EU taxonomy regulation.
- We also use information on a broader range of ESG factors, in particular with regard to the Principle Adverse Impacts (PAIs) such as the level of GHG emissions or biodiversity.
 - Due to the varying interpretations and applications (of EU Taxonomy and SFDR) by data vendors, Asset Managers' choice of ESG data provider will have a significant impact on the ESG / Sustainability profiles of their investments. This is both in terms of the data that is used internally to apply the regulation and in how this is communicated externally / reported to clients.
 - Transparency/reliability of data is key: the methodologies for estimating carbon data – and therefore the data itself – vary considerably from provider to provider. The same is true of the collection and verification methods that determine which carbon data is considered to be “reported”.
- Users would value a more granular categorisation of companies into different sectors. Ratings often cluster companies into broad sectors without providing granular analysis. The incorrect sector classification affects the comparison between companies because the material factors used to assess the rating may be different depending on the sectors.
- Users' choice of providers is also influenced by the coverage of rated companies, usually low for private ones, as well as the resources that the provider is endowed with.

To what degree do you consider the ESG ratings market to be competitive and allows for choice of ESG rating providers at reasonable costs, on a scale from 1 (not competitive) to 10 (very competitive)?

- The ESG ratings market has both expanded and contracted over recent years – with new players coming on to the market, but the larger ones consolidating even larger bases. It is for this latter reason that we believe it has become less competitive. The inability to offer a single rating product answering all users’ needs also introduces the need to rely on multiple rating providers. Low competitiveness, combined with the need for users to rely on multiple providers in a market with few participants, contribute to reducing choice and increasing costs in the market.

Questions for companies subject to ratings

Do you have access to ESG ratings of your own company?

- Yes
- No
- No opinion

- ESG ratings are usually – albeit not always – unsolicited, and there can often be very little interaction between score providers and companies.
- Companies may not be aware that they are rated by certain providers or may not receive updates when there are changes to their rating.
- 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.

To what degree do you use ESG ratings to assess the way you manage sustainability risks and opportunities and your impact on the outside world, on a scale from 1 (not determinant) to 10 (determinant)?

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If you do not use ratings, what do you use to assess the way you manage sustainability risks and opportunities and your impact on the outside world?

- Certain firms track progress in ESG performance against their strategic objectives, often assessing their sustainability risks and impact on the outside world on the basis of a double materiality assessment.
 - Progress is measured against internal KPIs, alongside regulatory indicators provided by TCFD, NFRD, Pillar 3 requirements, as well as the forthcoming CSRD and CSDDD.
- Firms rely on feedback from investors, clients, and external parties, combined with internal risk management practices (climate, rep, legal risk).

• Questions for all respondents

Do you consider that the market of ESG ratings will continue to grow?

- Yes
- No
- No opinion

If you responded 'yes' to the previous question, to what extent do you expect the following factors to be decisive, on a scale from 1 (not at all) to 10 (very much)?

7	Growth in demand from investors in ratings of companies for their investment decisions
6	Growth in demand from companies in ratings including on rating future strategies
8	Further standardisation of info disclosed by companies and other market participants
8	Other

If you responded 'other' to the previous question, please specify the other reasons you see for this market to continue to grow

- Growth in demand from financial institutions driven by regulation and increased reliance on third parties to meet disclosure requirements where companies are not required to disclose relevant sustainability information.
- Growth in demand from financial institutions for ESG financial risk management purposes.
- Growth in demand from financial institutions to structure ESG financial services and products (e.g., sustainability-linked bonds and loans).
- Growth in demand driven by an overall increase in the availability and quality of ESG information, in turn improving the reliability and quality of ESG ratings.

Are you considering to use more ESG ratings in the future?

- Yes, to a large degree
- Yes, to some degree
- No
- No opinion

If you responded 'yes' to the previous question, please explain why

- An overall increase in the use of ESG ratings will be a consequence of the key drivers described above.
- The increase is conditional on the ESG market's shortcomings being addressed as in recommendations for EU intervention outlined below. Certain firms will still choose to rely on their internal assessments.
- We expect market participants to increase the use of third-party ESG Ratings to demonstrate their ESG credentials and the solidity of their sustainability strategies

Do you mostly use ESG ratings from smaller or larger market players?

- Exclusively from large market players
- Mostly from larger market players
- Mixed
- Mostly from smaller market players

- Exclusively from smaller market players
- Not applicable

If you use mostly or exclusively ratings from large ESG rating providers, what are the main reasons for this?

Larger market players tend to be able to provide a broader coverage in terms of scope and global servicing. They also tend to be recognised as credible providers.

Users value in a ESG Rating provider the quality of its methodology and the amplitude of its database. Large market players, already established in the market for decades, are well placed to provide quality assessment and historical data, while also enjoying a certain standing and credibility in the investor community. However, even the larger players could improve the transparency of the methodologies used.

Nevertheless, some smaller providers are specialized in a given set of data, (Carbon, climate, controversies...) geographical, industry. To reach full coverage, users often need to rely on multiple providers. A wide variety of ESG ratings and data products have emerged, and the importance of these products in banks' processes have increased.

Only a small number of providers have a global presence. On the other hand, a larger number of smaller providers with a more regional focus or offering have more specialized services.

These smaller actors generally have a specific regional presence, specialization in specific data sets, coverage. There is also a number of start-ups and fintech companies entering the market and offering new products, which usually focus on using and leveraging big data and artificial intelligence in their product offerings.

Other reasons banks subscribe to services from multiple providers include complementarity of the data, and the possibility to benchmark and compare different methodologies in the absence of global standards for the industry.

There is no single data provider capable of meeting all of banks' ESG data needs (e.g. niche biodiversity data) or there may be insufficient width of data coverage or some ESG ratings may be used as market reference by clients.

Do you consider there is a sufficient offer of ESG ratings from providers located in the European Union?

- Yes
- No
- No opinion

If you responded 'no' to the previous question, please explain why

We observe a high level of concentration of US agencies in the market for ESG ratings and data. A recent wave of consolidation contributed to this trend. While their headquarters are established outside of the EU, most third-country ESG ratings and data providers have established a solid presence in the Member States and carry out their services from offices based in the EU. Despite potential biases due to different practices in the collection and interpretation of ESG information, those non-EU providers show sufficient knowledge and expertise in the EU markets where they operate. Nevertheless, this unbalance in the market reflects poorly on the competitiveness of European players vis-à-vis those established in other jurisdictions.

Finally, do you use other types of ESG assessment tools than ESG ratings (e.g. controversy screening, rankings, qualitative assessments, etc.)?

- Yes
- No

Do you believe that due diligences carried out by users of ESG research are sufficient to ensure an acceptable level of quality?

- Yes
- No
- No opinion

If you replied 'no' to the previous question, would you see merit in refining the current definition of research under Directive 2014/65/EU1?

5000 characters maximum

Do you further believe that ESG research products have reached a sufficient level of maturity and comparability to allow users to fully understand the products they use?

- Despite significant improvements over recent years, ESG research products have not reached yet a sufficient level of maturity due to the transparency and governance issues described throughout the response.
- We are concerned that some organisations blindly follow and factor in ESG ratings into their selection process without fully understanding and appreciating the significant shortfalls.
- With regard to maturity, ESG ratings need to keep up with user needs, in particular by developing methodologies and by identifying reliable data points to support analysis on broader ESG topics such as biodiversity and also focus more on impact analysis. It is therefore necessary that financial institutions are provided with more data on these topics in order to be able to offer corresponding products.
- Furthermore, the coverage of asset classes needs to be broadened since data provided is very limited or non-existent, for instance on real estate, sovereigns or illiquid.
- As more qualitative and quantitative ESG data will be provided by companies when the CSRD becomes effective and as financial products will become more transparent because of the SFDR, EET and EuGBS, we expect the scope of companies and products assessed to further grow.

II. Functioning of the ESG ratings market

How do you consider that the market of ESG ratings is functioning today?

- Well
- Not well

Please explain

- A well-functioning market would require adequate and meaningful engagement between providers of ESG ratings and rated companies.
- Market participants should be able to use ESG ratings providers to develop a clear view of the company's business, material sustainability impacts, and transition or adaptation plans.
- A well-functioning market also requires that providers and clients/users have a shared understanding of what the ESG ratings are measuring.
- In case of unsolicited ratings, data is frequently collected from public sources including company reports and, for controversy screening, from the media. These sources may be inaccurate or outdated and, if taken out of context, conclusions based on such information may be misleading for users. There is also sometimes a time lag between the data reported by the company and this being picked up in ESG ratings.
- While some providers provide processes to report inaccuracies in ESG ratings, the escalation process to report inaccuracies with unsolicited ESG ratings is frequently slow and time consuming and, in some cases, may imply obtaining a solicited (fee-paying) rating.
- As users of ESG ratings agencies, we believe that there is a lack of transparency regarding fees and clear explanations of complete product offerings, which makes choosing a provider difficult, time-consuming and resource-heavy.

To what degree do you consider that the following shortcomings / problems exist in the ESG ratings market, on a scale of from 1 to 10 (1- very little, 10 – important)?

6	Lack of transparency on the operations of the providers
10	Lack of transparency on the methodologies used by the providers
8	Lack of clear explanation of what individual ESG ratings measure
6	Lack of common definition of ESG ratings
6	Variety of terminologies used for the same products
8	Lack of comparability between the products offered
7	Lack of reliability of the ratings
7	Potential conflicts of interests
7	Lack of supervision and enforcement over the functioning of this market
8	Other

If you responded 'other' to the previous question, please explain which ones:

One of the main problems with the current ESG ratings provided by third party firms is the lack of alignment with investors' needs and regulatory obligations. ESG ratings are not specifically built or adequate for the various EU disclosure requirements: assessment of principles adverse impact (PAI), Taxonomy-alignment, Pillar 3 reporting, etc. There needs to be more clarity on methodologies also regarding PAIs – particularly the most complex ones. The disparity in ESG ratings also has an impact on what is considered "sustainable" by the market.

What do you think of the quality of the ratings offered on a scale from 1 (very poor) to 10 (very good)?

5

Please explain why:

- The quality of the ratings offered is defined by their reliability and comparability, which is negatively affected by the lack of transparency on providers' sources and methodologies, as well as the lack of appropriate engagement with rated companies.
- The lack of comparability and reliability of the underlying data also affects negatively the quality of the ratings offered.

If you responded 'very poor' or 'poor' to the previous question, to what degree do you consider that this affects your trust in the products that are offered, on a scale from 1 (no affect) to 10 (affects very much)?

8

Please explain why

The quality of the ratings offered is defined by their reliability and comparability, which is negatively affected by the lack of transparency on providers' sources and methodologies, as well as the lack of appropriate engagement with rated companies.

Do you consider that there are any significant biases with the methodology used by the providers?

- Yes
- No
- No opinion

If you responded yes to the previous question, please specify the biases

- Biases based on the size of the company rated
- Biases based on the location of the company
- Other biases

If you responded 'other biases' to the previous question, please explain which ones

- Most ratings only consider financial materiality and, as a result, the rating may not meet investors' expectations (including retail investors) unless providers clarify the purposes of the product and make sure to avoid confusion.
- Other potential biases stem from the condition of high market concentration in which providers operate.
- Given that some methodologies use different assessment factors depending on the sector, if the sector classification is not adequate, this can introduce bias, especially when

comparing two companies that should be in the same sector, but are classified in different sectors and therefore assessed with different factors.

Do you think the current level of correlation between ratings assessing the same sustainability aspects is adequate?

- Yes
- No
- No opinion

To what degree do you consider that a low level of correlation between various types of ESG ratings can cause problems for your business and investment decision, as an investor or a rated company, on a scale from 1 (no problem) to 10 (significant problem)?

5

- A study by the MIT Sloan Sustainability Initiative found that correlation among traditional credit ratings was 0.92, but for ESG ratings it was much lower at 0.61.
- A low correlation level hinders comparability and may be detrimental to the rated company depending on which ratings investors use or external stakeholders consider.
- However, it should be noted that different ESG ratings typically aim to measure different types of ESG factors. Hence, there is legitimate reason for the lower correlations amongst them, compared to traditional credit ratings.

How much do you consider each of the following to be an issue, on a scale from 1 (no issue) to 10 (very significant issue)

10	Lack of transparency on the methodology and objectives of the respective ratings
8	The providers do not communicate and disclose the relevant underlying information
2	The providers use very different methodologies
2	ESG ratings have different objectives (they assess different sustainability aspects)
	Other issue(s)

If you responded 'other issue' in the previous question, please explain which one(s)

- A low level of correlation is a problem where the methodologies adopted by providers are not clear and users are not able to weigh various factors according to their strategies. Correlation levels may also be affected by the availability of reliable and comparable ESG data from rated companies. Driven by investor pressure and disclosure requirements, a better flow of ESG information may contribute to improving correlation levels in the future.
- Low correlation could increase the risk for users, including investors, to select, for each company, the most favourable ratings that reinforce their strategies and decisions.

However, cherry-picking may lead to mis-allocation of capital for financial institutions, and may expose end-investors to an increased risk of greenwashing.

- A major problem for many players remains the pricing policy of the ESG rating providers. This can be measured in particular by what we consider as forced sale of data. Some rating Agencies do not sell their data individually or in detail, and their price list only contains a few items on data on specific entities or geographies of a company. As a result, when a financial company has a portfolio of companies that are present in several locations and/or different sectors, it is obliged to buy the global database on these companies. For example, a user may have to buy the global database without being able to check the quality of the data beforehand.

Do you consider that a variety of types of ESG ratings (assessing different sustainability aspects) is a positive or negative feature of the market?

- Rather positive
- Rather negative

Please explain your response to the previous question :

- Providers seek to differentiate their products and, in turn, their rating methodologies. Notwithstanding the issues described above, a variety in the products being offered is beneficial to the functioning of the market and to foster competitiveness.
- Having various types of ESG ratings on the market is positive as ESG factors may be difficult to aggregate and E, S or G ratings may well complement ESG ratings. Depending on the issuer's strategy, E, S and G factors may have different levels of relevance. Dedicated ratings to the E, S, and G factors (or breaking down an ESG rating into these 3 factors) would allow more transparency / accuracy on the issuer's strategy and actual impact actions.
- Standards or rules should not undermine the current diversity of methodologies/focues offered by ESG rating providers which is crucial for investors to inform their decision on which ESG data provider(s) to choose. Competitiveness should be maintained and stricter rules should not result in further concentration of these providers and reduced diversity.
- An Independent Oversight Committee could be implemented to provide the market with independent assurance that data and rating providers are meeting agreed best practices, serving the interests of their customers while treating issuers and other stakeholders fairly, with accuracy, integrity, and responsiveness. This framework would be like the one applied to the proxy advisor industry, for asset management activities.

To what degree do you consider this market to be prone to potential conflicts of interests on a scale from 1 (very little) to 10 (very much)?

7

If you responded 'yes' to the previous question, where do you see the main risks? (multiple choice)

- Where providers both assess companies and offer paid advisory services
- Where providers charge companies to see their own reports
- In the absence of separation of sales and analytical teams

- With the ownership system of some providers, where the parent company may exert undue pressure or influence on the research and recommendations that a ratings provider offers
- In the lack of public disclosure of the management of potential conflicts of interest
- Other conflict(s) of interest

If you responded 'other(s) conflicts of interest' to the previous question, please specify the additional risks you see

The offering of solicited and non-solicited ESG ratings by the same provider, as well as the offering of consultancy services for the same companies being assessed, may represent a potential conflict of interest. However, large ESG ratings providers have conflict of interest policies in place, in which they separate the operations of their rating and consultancy businesses.

To what degree do you consider that the ESG ratings market as it operates today allows for smaller providers to enter the market on a scale from 1 to 10 (1- hard to enter, 10 – easy to enter)?

5

What barriers do you see for smaller providers?

Covering an increasing number of issuers has become a key factor in choosing an ESG rating provider. The need to cover a large number of issuers can be a barrier for smaller providers. The development of AI technologies in data collection and processing may be a key factor from which smaller providers can benefit to remain competitive.

Smaller providers face many of the same issues as other small businesses, such as capital and brand/reputation building. Many smaller providers do not have the capabilities to provide coverage that companies require, however there is an opportunity for them to specialise in certain markets/sectors.

Do you consider that the market currently allows for smaller providers who are already present in this market to remain competitive on a scale from 1 (does not allow) to 10 (fully allows)?

5

To what degree do you consider the fees charged for ESG ratings to be proportionate to the services provided, on a scale from 1 (not proportionate) to 10 (very proportionate)?

4

- Ratings based on publicly disclosed data sourced from companies and put together by providers should have a certain pricing cap, while the data that is entirely formulated by the data provider themselves could be priced differently.

- ESG vendors also sometimes repackage existing datasets to create new products, inducing investors into paying twice for the same underlying datasets.
- In addition, the providers offer different pricing methods – some by package, some by location, some by number of users and some adopt a combination of these three methods. This makes it difficult to understand the true value/price of a product.

Do you consider that information on the fees charged by the providers is sufficiently transparent and clear?

- Yes
- No
- No opinion

If you responded 'no' to the previous question, please specify what you consider should be the minimum information to be disclosed

- More transparency is required when it comes to costs and product offerings (especially scope and coverage). This information should be clearly communicated to potential clients to allow for fair comparisons of providers and products.
- Pricing packages and uses of the ratings can be very restrictive. Fees are based on each ratings use and are calculated in a way that is hard to map out and trace back. In addition, there is a lack of transparency about applied fees and tariff offers.
- We would like the following information on fees to be disclosed:
 - The mention of a notice period in case of changes to the essential qualities of the contract (such as tariffs) and that this should not be imposed without prior notice by the data providers.
 - The mention in contracts of the notion of data re-use (data providers consider that re-use of their data - even after in-house processing - entitles them to charge not only their client [e.g. bank A] but also bank A's clients who benefit from its services). The mention of these elements in the information shared by the providers would put an end to arbitrary cost overcharges set up by the latter.

III. EU intervention

In light of the current situation and recent developments of the ESG ratings markets, and the potential issues affecting it, this section aims to gather stakeholder views on the need and type of a possible intervention at EU level.

a) Need for an EU intervention

Taking into account your responses to the previous sections, do you consider that there is a need for an intervention at EU level to remedy the issues identified on the ESG rating market?

- Yes
- No
- No opinion

Please explain why :

- EU intervention should address in the short-term the issues described, through a common, harmonised and enforceable framework for transparency and governance and by drawing common definitions and best practices.
- Any measures should be developed in line with existing and upcoming sustainability disclosure requirements, and aim at improving the availability of reliable information.
- Guidelines should be effective and proportionate, ensuring the sector can continue to innovate and evolve alongside the market's understanding of sustainability issues.
- Measure should not prevent smaller or boutique providers, including NGOs, investor initiatives and semi-commercial operators, from participating in the market.
- It would be beneficial to expand ESMA's remit and set up a registration and supervision regime for ESG ratings providers.
- EU intervention should be coordinated with international bodies and, in particular, should be consistent with IOSCO's [recommendations](#) for securities markets regulators. In principle, EU regulation should be widely aligned with international sustainability baseline standards and with future initiatives which can be put forward in other major jurisdictions (e.g. by the UK FCA).

If you responded yes to the previous question, what type of intervention would you consider necessary?

- Non-regulatory intervention (e.g. guidelines, code of conduct)
- Legislative intervention

If you responded yes to the previous question, what do you consider should be the prime focus of the intervention? (multiple choice)

- Improving transparency on the operations of the providers,
- Improving transparency on the methodology used by the providers.
- Improving the reliability and comparability of ratings.
- Clarifying what is meant by and captured by ESG ratings, to differentiate from other tools and services.
- Clarifying objectives of different types of ESG ratings,
- Improving transparency on the fees charged by the providers.
- Avoiding potential conflicts of interests.
- Providing some supervision on the operations of these providers.
- Other measures (please specify).

For each of the points you selected in the previous question, please explain what solutions and options you would consider appropriate

- Improving transparency on the methodology used by the providers: providers should be asked to publish information on the methodology used for their ratings in line with common transparency rules. Providers should ensure transparency on the results of their materiality assessment for each sector and rated company, which metrics have been selected as relevant, and what weight has been attributed to each of these.
- Improving the reliability and comparability of ratings: providers should be asked to specify the sources of data, the time stamp of the data, and whether the information have been provided directly from rated companies, are based on estimates, or have been collected from public sources. Providers should also specify the objectives and intended use of their products, for instance whether the product is measuring ESG risk or

sustainability impact. It would be preferable for ESG rating providers to make public the relative weight of the various indicators, the time span of the data used and the impact of relevant events such as controversies on the scores. In addition, explanations with respect to shortcomings of certain methodologies would be helpful for investors.

- Avoiding potential conflicts of interests: intervention could seek to introduce harmonised minimum disclosures on how providers identify and prevent potential conflicts of interest through their governance arrangements and enhanced transparency, including by ensuring a clear separation among the functions or departments involved in consultancy services and the analysts evaluating the companies.
- Providing some supervision on the operations of these providers: expanding ESMA's remit and set up a registration and supervision regime for ESG ratings providers.

If you responded 'other' to the previous question, please specify the other elements the intervention should focus on

- Fostering better governance and engagement with rated companies: EU intervention should draw best practices on the governance around the provision of ESG ratings.

Proportionate rules should spell out how rating providers engage with rated companies, with the aim to collect data directly, where possible, and complement scores with any relevant contextual information on the rated company's business and outlook.

Rules must also ensure that rated companies are 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.

- Further, the involvement of the rated entities in the rating process should be strengthened and providers should ensure there are in place appropriate avenues for rated companies to review ratings before these are published. The opportunity for rated companies to respond and be given notice of a change to rating is essential and we believe this should be standardised across the ESG ratings market. As highlighted in our response, ESG ratings have increasing importance in driving financial flows / external reputation, making the need for (i) a notice requirement of unsolicited ratings being prepared or existing ratings being updated and (ii) the opportunity to respond to inaccuracies increasingly important.
- Communication of changes in ratings. From a user's perspective, in cases where an ESG rating score is changed for a company, we consider that EU intervention should look to apply transparency and communication similar to those that are mandated for CRA rating changes. If users / market participants are not reasonably notified of a change in ESG rating, this can lead to distortions within the market.

Do you consider that the providers should be subject to an authorisation or registration system in order to offer their services in the EU?

- Yes
- No
- No opinion

Please explain why :

- We find it would be beneficial to expand ESMA's remit and set up a registration and supervision regime for ESG ratings providers.

- Registration is necessary for external ratings to be recognized in the wider EU legal framework.
- Authorisation or registration is a prerequisite for supervision. We think EU supervision by ESMA is necessary to ensure enforcement of EU requirements.
- Given the amount of ESG ratings providers currently in the market, it would be useful to know which are “authorised” to ensure credibility when choosing a provider.

Do you consider that the providers should be subject to an authorisation or registration system in order to provide ESG ratings on EU companies or non-EU companies’ financial instruments listed in the EU even if they offer services to global or non-EU investors?

- Yes
- No
- No opinion

Please explain why

To enhance comparability among providers and a consistent application of transparency rules, an authorisation or registration system would also have to apply to providers rating EU companies or non-EU companies’ financial instruments listed in the EU.

However, measures should not erect barriers for providers and, to ensure that also those offering services to global or non-EU investors can continue to provide ratings on EU companies and offer their products in the EU, proportionate measures such as a certification/endorsement regime like the one in place for CRAs should be adopted.

Do you consider that there should be some minimum disclosure requirements in relation to methodologies used by ESG rating providers?

- Yes
- No
- No opinion

Please explain why

- The introduction of minimum disclosure requirements in relation to methodologies used by ESG rating providers should be the prime focus of EU intervention. Transparency is needed to improve trust in, and reliability of, ESG ratings.
- Providers may be asked to publish information on the sources of data, the methodology used for their ratings and their fee structure in line with common transparency guidelines.
- Providers should consider labelling ESG ratings more clearly depending on what they rate (e.g., ESG risk ratings or ESG disclosure ratings) to address possible confusion among ratings measuring different things being called ESG ratings regardless.
- Providers should ensure transparency on the results of their materiality assessment for each sector and rated company, which metrics have been selected as relevant, and what weight has been attributed to each of these.
- Providers should disclose the policies they adopt to address conflict of interest.
- Additional key information needed are the following:

- The main sources of data used
- The procedure to ensure the quality of the analysis and ratings, and the qualification of analysts (including knowledge of the local ecosystem);
- The integration of national specificities / local ecosystem and rated company specificities into the analysis, including how it is taken into account;
- The dialogue with the rated company

Do you consider that the providers should be using standardised templates for disclosing information on their methodology?

- Yes
- No
- No opinion

Please explain:

- It may be premature to introduce a mandatory, close-ended template for providers to disclose information on their methodology.
 - A one-size-fits-all template would not fit given the diversity of rating products offered by providers and with the pace of development of new products in the market.
 - The red tape introduced by standardised templates may affect disproportionately boutique providers, or discourage possible new entrants in the ESG ratings market.
 - Regional and sectoral differences will also affect the classification of sustainable activities and the definition of transition paths and, in turn, rating methodologies.
- A voluntary, standardised template, part of a broader set of guidelines and based on a review of best practices, is the preferred option to enhance transparency and comparability while offering flexibility and maintaining a level-playing field.

Do you consider that the rules should be tailored to the size of the provider and hence have smaller providers subject to a lighter regime?

- Yes
- No
- No opinion

Should the providers located outside of the EU, not providing services to the EU investors but providing ratings of the European companies/financial products be subject to a lighter regime?

- Yes
- No
- No opinion

PART B – INCORPORATION OF ESG FACTORS IN CREDIT RATINGS

I. Questions to users of credit ratings

Do you use credit ratings for investment decisions?

- Yes, as a starting point for internal analysis
- Yes, as one of many sources of information that influence investment decisions
- Yes, as a decisive input into an investment decision
- No
- Other

Do you use credit ratings for regulatory purposes (e.g. stemming from the Capital Requirements Regulation or Solvency II)?

- Yes
- No
- These requirements don't apply to me

Is it important for you to understand to what extent individual credit rating actions have been influenced by sustainability factors?

- Not important at all
- Slightly important
- Important
- Very important
- No opinion

Do you find information about the extent to which CRAs methodologies or the rating process incorporate sustainability factors sufficiently well disclosed?

- Yes
- No
- No opinion

Please explain

While the methodologies are still not sufficiently well disclosed, we have seen a marked improvement over the past year due to pressure from asset owners.

Where do you look currently for the information on how ESG factors impact the credit rating? (multiple choice)

- Press release accompanying credit ratings
- Additional analysis and reports available to subscribers
- Additional information materials available publicly
- Description of methodologies or rating process for specific asset classes, sectors or types of entities
- Frameworks or documents describing general approach to incorporation of ESG factors in credit rating process
- I don't know where to find such information
- Other

If you responded 'other' please explain where:

Individual sessions/workshops with ESG rating agencies.

Does the level of disclosure differ depending on individual CRAs?

- Yes
- No
- No opinion

What are the trends on the market in relation to disclosure of information as to which credit ratings actions have been influenced by sustainability factors? (multiple choice)

- The level of disclosure has improved sufficiently since the entry into effect of ESMA guidelines (April 2020)
- In general the level of disclosure has improved sufficiently although some CRAs are lagging behind
- The overall level of disclosure is insufficient although some CRAs have sufficiently improved

The extent to which CRAs incorporate ESG factors in credit ratings depends on the asset classes methodologies and the importance assigned to the given factor by a CRA's methodology. In addition, some CRAs have developed overall frameworks explaining how they incorporate ESG factors in credit ratings across asset classes, some publish reports reviewing past credit rating actions or specific sections accompanying credit rating actions.

In your opinion, what are trends in the relation to the incorporation of ESG factors in the credit rating process and methodologies?

- CRAs have sufficiently improved the incorporation of ESG factors in their methodologies and rating process,
- In general CRAs have sufficiently improved the incorporation of ESG factors in credit ratings although some CRAs are lagging behind
- In general the development is insufficient although some CRAs have improved the incorporation of ESG factors in their methodologies and rating process,
- CRAs have insufficiently improved the incorporation of ESG factors in their methodologies and rating process

II. Questions on the need for EU intervention (all respondents)

Do you consider that the current trends in the market are sufficient to ensure that CRAs incorporate relevant ESG factors in credit ratings?

- Yes
- No
- No opinion

Do you consider that the current trends in the market and application of ESMA guidelines on disclosure applicable to CRAs are sufficient to ensure understanding among users as to how ESG factors influence credit ratings?

- Yes
- No

- No opinion

If you responded 'no' to the previous questions, what type of intervention would you consider necessary? (multiple choice)

- Further detailing of ESMA guidelines on the disclosure of ESG factors in credit ratings
- Further supervisory actions by ESMA
- Legislative intervention.
- While improvements are insufficient, we do not see further scope for EU intervention
- Other, please specify

Regarding the possible regulatory intervention, what type of requirements do you find relevant? (multiple choice)

- Press releases: introduce mandatory requirements mirroring the provision of ESMA guidance on the disclosure ESG factors in credit ratings
- Press releases: in addition to the previous option require CRAs to publish information not only about the impact of ESG factors on credit ratings, but also the lack of it,
- Methodologies: require CRAs to explain the relevance of ESG factors in methodologies.
- Methodologies: require CRAs to take into account ESG factors where relevant.
- Other.

What kind of risks or merits of the EU intervention do you see?

- Provide further clarity on the impact of ESG factors on the creditworthiness of creditors and financial instruments
- More coherent approach of CRAs to the incorporation of ESG factors into credit ratings
- Concerns about too much prominence given to ESG factors
- Others

What would be the consequences of the lack of the EU intervention? (multiple choice)

- Market trends are sufficient to meet investors demands for information on the impact of ESG factors on credit ratings
- CRAs will respond to market pressure and ensure the incorporation of ESG factors in credit ratings
- The existing gap between approaches of CRAs to the incorporation of ESG factors in credit ratings will grow
- Concerns about the insufficient incorporation of ESG factors in credit ratings lack of understanding among investors why certain credit rating actions are not impacted by ESG factors

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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

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