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European Commission
Directorate-General for Financial Stability,
Financial Services and Capital Markets Union
European Commission
1049 Brussels
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Submitted via online survey

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Dear Sir or Madam,

AIMA comments on 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

The Alternative Investment Management Association (AIMA)[1] welcomes the opportunity to respond to the European Commission's consultation on ESG ratings and the consideration of ESG factors in credit ratings.[2] Given the significant growth in this market we believe it is right to consider whether additional regulation might be appropriate.

Part A – ESG Ratings

1. *Use of ESG ratings and dynamics of the market*

When it comes to the products offered by ESG ratings and data vendors, our members are more likely to purchase granular ESG data, rather than ESG ratings themselves. Members typically use

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1 The Alternative Investment Management Association (AIMA) is the global representative of the alternative investment industry, with around 2,100 corporate members in over 60 countries. AIMA's fund manager members collectively manage more than US$2.5 trillion in hedge fund and private credit assets. AIMA draws upon the expertise and diversity of its membership to provide leadership in industry initiatives such as advocacy, policy and regulatory engagement, educational programmes and sound practice guides. AIMA works to raise media and public awareness of the value of the industry. AIMA set up the Alternative Credit Council (ACC) to help firms focused in the private credit and direct lending space. The ACC currently represents over 250 members that manage US$600 billion of private credit assets globally. AIMA is committed to developing skills and education standards and is a co-founder of the Chartered Alternative Investment Analyst designation (CAIA) – the first and only specialised educational standard for alternative investment specialists. AIMA is governed by its Council (Board of Directors).For further information, please visit AIMA's website, www.aima.org.

2 https://ec.europa.eu/info/sites/default/files/business_economy_euro/banking_and_finance/documents/2022-esg-ratings-consultation-document_en.pdf

this data to build their own in-house analytical framework, in preference to using ratings based on an external provider's methodology. Developing an in-house framework allows for flexibility over the interpretation of data and means that the analysis can be tailored to the portfolio and the specific ESG characteristics that members are interested in.

Accordingly, the most important issue for our members is ensuring the quality and accessibility of this underlying ESG data (often this is corporate data, although it could also relate to non-corporate investments). We are therefore very supportive of the work being conducted by the ISSB on corporate disclosures to ensure data is robust and globally consistent as far as possible. We believe it is crucial to further align the definitions that underlie key ESG metrics, to ensuring greater comparability of the information that is disclosed.

Despite the emphasis placed on granular ESG data, ratings are nevertheless used to some extent by our member firms: as a proxy to understand the ESG positioning of a company and to flag relevant risk that may be impactful to the investment; for engagement with corporates (i.e. to drive engagement topics and as a starting base for discussions); and potentially in the decision-making process, when making an investment decision, noting that a firm will consider many attributes beyond ESG considerations when making an investment. Firms might also use ratings in the context of reporting to investors on the performance of their products, either as a standard approach or in cases on request.

II. Functioning of the ESG ratings market

In our view, there are a number of issues with the ESG ratings market and how it functions.

Firstly, there is currently a lack of transparency regarding the methodologies used by ratings providers, which can make it challenging for investment managers to validate a given rating or assess its limitations. In addition, there is inconsistency in approaches and a lack of transparency over how controversies drive ratings. While an investment manager might direct questions to a ratings provider about its approach to particular issuers, our members have generally found that ratings providers are not particularly responsive to questions or concerns.

There are also issues over the timeliness of updates to ratings, with updates potentially occurring several months after a company releases an ESG report. This can limit the usefulness of ratings from a user perspective.

Ratings might also fail to sufficiently account for social issues within their frameworks and can be biased towards larger companies. Firms with an investment focus on SMEs will often have to develop their own analytical frameworks, as these companies are not necessarily covered by external ESG ratings providers.

Pricing is another area that is problematic. Our members note that fees are not always sufficiently transparent and clear. Pricing structures are often opaque, and it is not always clear what is included in different packages, leading to significant 'bolt-on' prices.

III. EU Intervention

a) *Need for an EU Intervention*

Despite some of the shortcomings in the market for ESG ratings and data, we do not believe there is a need for regulation at this time. Instead, we believe it is better to focus on a Best Practice Code for ratings providers, rather than seek to develop formal regulatory requirements, given the risk that these would create additional disproportionate costs that are passed onto users of ratings and ESG data. We are also concerned that overly prescriptive regulations or standardised disclosures could stifle development in a market that is still relatively new. It would be of concern if any regulation were such that it prevented providers from developing and refining their approaches.

We also note that ESG ratings do not have the same potential systemic impact as credit ratings, although we believe it is reasonable that the EU should keep under review the potential of ESG ratings (downgrades) to prompt large price moves in a way that might call for direct supervision in the future.

To the extent that a regulatory framework is ultimately established, we believe the focus of any future intervention should be on the transparency of ratings providers' methodologies, as well as the mitigation and disclosure of potential conflicts of interest. As noted above, our members have experienced challenges in terms of understanding and validating the approaches used by different ratings providers, which suggests a need for greater transparency for users of ratings regarding the underlying methodologies. Additionally, greater transparency on the data that is included within ESG ratings, for example, the reference period a rating is based on, would be beneficial to help investors understand what a rating is, and is not, showing. Some oversight of pricing might also be beneficial to ensure that pricing is commercially reasonable and non-discriminatory.

As mentioned previously, further work on corporate disclosures to ensure that the data being used in ESG ratings is reliable and consistent should remain the priority – this implies greater global standardization of the definitions that underlie key ESG metrics, as well as more open access to datasets that are currently collated by NGOs, including CDP. We believe that increasing the quality and comparability of this data will not only benefit those who use this data directly but will also improve the quality of ESG ratings.

We would be happy to elaborate further on any of the points raised in this letter. For further information, please contact Kate Boulden, Associate Director, Governance and Innovation, by email at kboulden@aima.org.

Yours sincerely,

Adam Jacobs-Dean
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