EFAMA

European Fund and Asset Management Association

CONSULTATION RESPONSE

Brussels, 08 June 2022

EFAMA'S RESPONSE TO THE EUROPEAN COMMISSION CONSULTATION ON THE FUNCTIONING OF THE ESG RATINGS MARKET IN THE EU AND ON THE CONSIDERATION OF ESG FACTORS IN CREDIT RATINGS

The European Fund and Asset Management Association (EFAMA) welcomes the opportunity to respond to the EC's targeted Consultation on the functioning of the ESG ratings market in the EU and on the consideration of ESG factors in credit ratings. While EFAMA regrets the too short time frame for answering the European Commission's detailed questionnaire, we would nevertheless like to provide our observations on the evolution of the ESG ratings market, share our perception of shortcomings and risks, as well as our recommendations to enhance the ESG ratings market in the European Union.

Please note that our response covers ESG ratings and ESG data providers. It is important to also cover the latter, as demand for ESG "raw" data has been increasing at a steady pace, in good part due to the recent regulatory developments. Thus, both ESG ratings, as well as ESG data providers, need to be considered in parallel for any planned intervention. Whilst currently the need for action is likely to be higher for ESG rating provision than ESG data provision due to the historical use of ESG rating within the investment process, we believe that this will soon change as financial market participants aim to comply with regulations requiring the disclosure of these data metrics.

EVOLUTION OF THE MARKET

The market for ESG ratings and data products has rapidly grown and is only expected to continue growing at pace over the coming years. Opimas has estimated an annual growth of 20% for ESG data and of 35% for indices in 2022 whilst noting 60% of ESG data spending is driven by EU regulatory developments. Its report also showed that asset managers are the heaviest consumers of ESG data products (59%)[1]. The use of ESG data has also rapidly shifted from a narrow set of investment products to being prolific across all investment products.

The rapid market growth is due to the increasing legislative and regulatory focus on ESG considerations of potential investments as well as the increasing demand from investors. In addition, the lack of mandatory, consistent and publicly available ESG data from investee companies has also led to a heavy reliance from our members on third-party ESG ratings and data providers and their capacity, among others, to establish a dialogue and collection procedures with many investee companies as well as model estimations; However, the ESG ratings and data providers still suffer ESG data problems. Therefore, the fact that

[1] See "ESG Market Data: No Stopping its Rise Now", Opimas, 9 March 2020

financial market participants are being mandated to produce disclosures on sustainability-related matters ahead of the investee companies raises the risk that some data and ratings would not be reliable, which could undermine the trust in the whole chain (rating and data provider, financial market participant and its end clients).

SHORTCOMINGS AND RISKS POSED TO ORDERLY MARKETS, FINANCIAL STABILITY AND INVESTOR PROTECTION

Given the increasing importance of ESG ratings in the markets in supporting financial actors' risk management and the role they play in the investment decision process, it is essential to ensure these products are transparent and reliable. We acknowledge that market research providers and sustainability ratings agencies have increased their efforts to address weaknesses in terms of accuracy, quality assurance of the ratings provided to the client, and breadth and depth of analysis. However, there is still a lot of room for improvement. Most of these concerns have also been highlighted in the IOSCO final report (i.e. to improve the transparency around ESG ratings methodology and data sources, to enhance data quality through internal controls and governance, and to ensure a robust and transparent governance process to avoid potential conflicts of interest), which we fully support. To ensure consistency, we fully support the development of and use of aligned definitions at a global level.

Lack of transparency in the methodology and data used

A theme extensively highlighted by EFAMA members is the very low correlation between ESG scores from different data providers for the same portfolio[2]. While a certain level of divergence is appreciated by investors, reflecting the subjective nature of ESG including different calculation approaches (e.g. weighting across ESG elements), measurement differences (e.g. rating providers using different indicators to measure the same attribute) and scope differences (e.g. rating providers using different attributes), there is a necessity to provide more transparency on the methodology, data used and frequency of revision. Without granular transparency, asset managers are unable to ascertain that the information provided matches with their own ESG view and can be safely relied on in the context of their investments and product development strategies. We also believe that transparency will promote the 'shopping around' in terms of ESG rating providers to ensure that the attributes and indicators they are using match what a financial market participant would normally cover as part of their investment research.

There is also a parallel issue concerning data collection and estimation methods. There are considerable areas of variability in the data used, often sourced from bespoke company questionnaires placing different emphasis on ESG policies or estimates. On ESG index providers, in particular, we note that they usually require ESG data to be used from their owned ESG data provider(s). As mentioned previously, the industry recognises that third-party providers face important challenges due to the lack of ESG company data. That being said, asset managers suffer from the lack of transparency regarding which data has been obtained directly from investee companies and which data has been estimated including how the data has been estimated. It is important to underline that a divergence in ratings in itself is not a problem, as long as there is sufficient transparency about the processes used to arrive at the rating. Our members feel that the estimation methodologies currently used by ESG rating providers are still very opaque, sometimes also lacking substantiative evidence, thus making due diligence and monitoring from asset managers quite difficult.

Data collection and estimation have become even more challenging since the introduction of new obligations for financial products under the EU Taxonomy (i.e. the alignment assessment based on the Technical Screening Criteria (TSC)) and SFDR (i.e. the Principal Adverse Impact (PAI) considerations).

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[2] See "ESG Ratings: Navigating Through the Haze", CFA Institute, 10 August 2021

Our members reported that third-party providers have not yet applied the TSCs adopted by the European Commission and are not yet in a position to provide complete and high-quality data in relation to the PAIs[3]. It is in this ESG data landscape that financial market participants have started disclosing their Taxonomy alignment and PAI reporting in respect of the reference period from 1 January 2022.

While this situation is expected to improve as third-party providers will gradually integrate these elements, the lack of transparency in the methodology and data used will make it extremely difficult to assess whether a particular vendor's product complies with the legal requirements that apply to asset managers.

As a result, the usability of ESG ratings and data providers by asset managers is greatly limited by the lack of transparency in the type of data and methodology used and one of the greatest challenges facing users is the incapacity to effectively evaluate ESG vendors across different use cases. In addition to leading to potential misallocation/mispricing of investments, the lack of transparency and comparability – and therefore of reliability – of the current ESG ratings and data products available will most likely confuse end investors and undermine their trust and confidence in sustainable financial products.

Market concentration and the rising cost of ESG data services

As the IOSCO final report rightfully highlights, the market is currently dominated by a handful of powerful providers who control a significant market share. This growing oligopoly gives these global providers substantial market power and the ability to set excessively high fees. This spike in the cost of ESG data service is particularly detrimental to smaller firms with fewer resources and bargaining power and ultimately affects end investors as potentially these costs may be passed on to them. Members have also expressed concerns regarding the lack of transparency in the pricing and licensing frameworks, which largely depends on the combination of data modules and the size of ESG assets under management of clients.

Another risk is also related to the concentration of ESG data providers in recent years which results in an oligopoly situation in the hands of global providers which are not in the scope of the EU framework. This situation places EU market participants in a weak and captive position for gathering the requested ESG data to comply with EU regulations. We believe a key objective should be to ensure these providers develop globally consistent frameworks and standards that are compatible with the requirements of the EU legislation.

EFAMA's recommendations to enhance the ESG ratings and ESG data providers market in the European Union

We would like to point out that EFAMA's position on the need for a code of conduct versus a regulatory framework has evolved since our response to the ESMA consultation.

In our previous ESMA response, we suggested that a voluntary code of conduct would be sufficient. Asset managers still support such a code, given that it would allow for much-needed flexibility and not stifle innovation given the relative immaturity of the market. Also, its setup and implementation could be achieved quicker than a regulatory framework.

This being said and with the experience in the credit ratings agencies space in mind, we have substantial concerns that the development of such a code may ultimately not be sufficient. Although we are fully conscious of the difference between ESG-related service providers and CRAs, there are substantial doubts

[3] See "Principal Adverse Impacts Reporting – Practical Insights for the Next Stage of SFDR Implementation", Irish Funds, August 2020.

that such a code of conduct may not find the backing of a sufficient number of ESG ratings and data providers and may also be lacking a strong supervision mechanism.

#1 The development of a regulatory framework for ESG ratings and ESG data providers

In light of our above comments and observations regarding the current shortcomings of the ESG ratings market and investors' regulatory reporting obligations, EFAMA sees the need for swift development of **a regulatory framework based on the following principles** (while guaranteeing proportionality and continued market innovation):

- **Improving the transparency around ESG ratings methodology and data sources** – A legal framework should provide more detailed disclosures of the methodologies and models applied. As a minimum, those disclosures should provide a description of the products offered, the source of the raw data used, the controls applied, the frequency of revision of the methodologies and the measures taken to avoid possible conflict of interests. As an additional step to better transparency, it could be considered to provide additional evidence of how their methodologies are built to ensure they contribute to providing accurate and reliable data on a company's ESG performance, and how this aligns with their stated mission.

  This being said, the regulatory framework should not standardise the underlying methodologies to allow providers sufficient flexibility to use a wide range of methods and approaches.

  In addition, the framework should also encourage providers to incorporate the ongoing regulatory changes into their framework to help ensure the quality and robustness of the processes to define or extract a particular ESG rating and data. This especially applies to the ESG data space, where methodologies are stipulated in the existing regulatory framework.

  This increased transparency would allow asset managers to ensure that any products used comply with the requirements that apply to financial products (e.g. under the EU Taxonomy and SFDR) and would boost investors' confidence in the varying ESG-related service offerings. Ultimately, we are also advocating for more transparency whenever ESG ratings are re-assessed as these have implications on investment decisions that have considered these ratings.

- **Enhancing data quality through internal controls and robust data governance** – We also recommend more consistency in the way providers collect ESG data, as well as the development of a common set of quantifiable critical data elements that would be consistent with the existing framework for reporting requirements and assessment methods. In addition, EFAMA would encourage providers to commit to an adequate update frequency of ESG data products. Member highlighted that the low frequency of updates affects their ability to use voting as a tool to drive companies' ESG behaviour in a timely manner. Given the pace of change in the ESG space, we believe that the current minimum required update of once a year is insufficient and argue that the frequency should be based on how frequent the underlying data is updated by investee companies. For example, companies follow different financial periods and as such a fixed date for updates will not be sufficient, as some investee companies may not issue updated accounts until after that fixed date. We also encourage more transparency regarding the update cycle for each aspect of the ESG ratings and data products. This information should be available for each company covered and allow investors to understand when each part of the analysis/data was last updated.

- **Ensuring a robust and transparent governance process to avoid potential conflicts of interest** – To preserve market integrity, the legal framework should ensure specific requirements relating to internal controls and governance processes. The fast increase of commercial offers for ESG ratings, as well as the concentration of providers and their function as ESG service providers

to rated companies, increase the risk of potential conflict of interest. We see this, especially with ESG index providers which usually require ESG data to be used from their owned ESG data provider.

Therefore, the framework should cover organisational and operational requirements (e.g. governance and internal control requirements including effective arrangements to identify, manage or prevent conflicts, review function responsible for the review/audit of methodologies including significant changes to these methodologies, not discriminatory fees covering both parent groups and subsidiaries) to ensure that the risk of conflicts of interest will be minimised. For ESG indices, this should mean that clients creating ESG indices should be able to specify which (reputable) ESG data to be used.

- **Addressing the pricing and license power of ESG ratings and data products providers** – We urge the European Commission to also consider the pricing policies applied by ratings and data providers and to take actions to enhance fee transparency and fee breakdown. It is of utmost importance that lawmakers and supervisory authorities gain a better overview of the costs and revenues charged to identify possible violations of the non-discrimination and cost-based/cost-related principles laid down in the various national regulations. For instance, supervisory authorities could collect annual information on pricing, licenses, costs and revenues per type of ESG ratings, ESG data service and ancillary services in addition to fees and costs for rating related products and services sold by other entities within the group. Collecting such information would lead to a better understanding of the services provided by rating agencies and their entities within the group.

- **Improving on the overall coverage of companies** – In addition, we highlight that there is a heterogeneous coverage of companies: with satisfactory scores for large capitalisations and companies from developed countries and lacking or missing data for other types of companies. Cultural specificities also generate a bias depending on the provider's nationality and ESG philosophy. These biases, and the variation that occurs across methodologies, contribute to creating a high divergence and weak correlation among scores from different rating companies.

- **Ensuring a proportional coverage of EU and non-EU ESG ratings and data providers** – The legal framework must also consider that ESG ratings and data providers are offering their services both from within the EU as well as from third countries into the EU. The legal framework should ensure that all major players providing services to EU financial market participants are within scope. To ensure the necessary proportionality, we could foresee that providers not yet established in the EU should be required to do so once their percentage of overall EU revenues reaches a certain threshold. This should guarantee the continuation of services from smaller providers from outside the EU while safeguarding the future framework and providing a level-playing field.

#2 The parallel development of a voluntary code of conduct for ESG ratings and ESG data products providers

While advocating for a legal framework, we still consider that, in **parallel to legal intervention, a voluntary code of conduct could be developed**. This voluntary code should aim at achieving the same objectives as set out above. Due to the hopefully quicker set-up of such a voluntary code compared to a legal framework, it could help the European Commission correctly calibrate the future legal framework. EFAMA stands ready to engage with the ESG ratings and ESG data products providers, ESMA and the European Commission on the swift development of such a code.

#3 Continue to work towards alleviating the data gap and allow financial market participants to act on a 'best effort' basis for live and pending regulatory obligations

To reduce the reliance of asset managers on providers in Europe, EFAMA urges the Commission to improve the availability of underlying ESG data and the consistency in non-financial company reporting, both at the EU and international levels. We very much support the **development of a new consistent sustainability reporting framework under CSRD**, the international convergence on sustainability reporting standards and the development of the European Single Access Point (ESAP). Furthermore, we believe that the implementation of the reporting framework under CSRD should be prioritized to allow the effective reduction of the data gap.

With regards to the consistent sustainability reporting framework under CSRD, we very much welcome the ISSB's consultation on sustainability-related reporting exposure drafts as well as EFRAG's consultation on the draft EU Sustainability Reporting Standards (ESRS). Both of these consultations are currently being considered by EFAMA.

EFAMA is actively supporting all the initiatives which will help reduce reliance on ESG data providers over time.

ABOUT EFAMA

EFAMA, the voice of the European investment management industry, represents 27 member associations, 59 corporate members and 25 associate members. At end Q4 2021, total net assets of European investment funds reached EUR 21.9 trillion. These assets were managed by more than 35,000 UCITS (Undertakings for Collective Investments in Transferable Securities) and more than 30,000 AIFs (Alternative Investment Funds). At the end of Q3 2021, assets managed by European asset managers as investment funds and discretionary mandates amounted to an estimated EUR 31.3 trillion.

More information is available at www.efama.org

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