

Call for evidence On Market Characteristics for ESG Rating Providers in the EU

Abbreviations and definitions

Abbreviations

- **EC:** European Commission
- **ESG:** Environmental, Social, Governance
- **EU:** European Union
- **ESMA:** European Securities and Markets Authority
- **IOSCO:** International Organization of Securities Commissions

Definitions

For the purposes of this paper the terms ESG ratings and ESG data products are understood as those set out in International Organization of Securities Commissions's (IOSCO) Final Report on Environmental, Social and Governance (ESG) Ratings and Data Products Providers[1].

- **ESG data products:** refer to the broad spectrum of data products that are marketed as providing either a specific E, S, or G focus or a holistic ESG focus on an entity, financial instrument, product or company's ESG profile or characteristics or exposure to ESG, climatic or environmental risks or impact on society and the environment, whether or not they are explicitly labelled as "ESG data products".
- **ESG ratings:** refer to the broad spectrum of ratings products that are marketed as providing an opinion regarding an entity, a financial instrument or a product, a company's ESG profile or characteristics or exposure to ESG, climatic or environmental risks or impact on society and the environment that are issued using a defined ranking system of rating categories, whether or not these are explicitly labelled as "ESG ratings".

[\[1\] FR09/21 November 2021](#)

1. Introduction

1. On 28 January 2021, ESMA wrote to the European Commission (EC) to advise that it considered the unregulated nature of ESG ratings and data assessments posed a potential risk to investor protection. To mitigate these risks ESMA highlighted the need to match the growth in demand for these products with appropriate regulatory requirements, to ensure their quality and reliability.
2. This letter was followed by the publication of the EC's Strategy for financing the transition to a sustainable economy on 6 July 2021. As part of this strategy, the EC announced that it will take action to improve the reliability, comparability and transparency of ESG ratings[1]. In order to achieve this, the EC committed to launching a public consultation. This public consultation is intended to gather information on the issue, with a view to developing an impact assessment on the costs and options of a possible EU intervention.
3. With a view to receiving supporting evidence for this process, the EC addressed a request for support to ESMA on 12 November 2021. This request noted that ESG ratings are used by a wide variety of investors to take into account risks and opportunities linked to ESG issues. In addition, it noted that these products are having an increasingly important impact on the operation of capital markets and on the confidence of investors in sustainable finance products. As a result, the EC requested that ESMA conduct a call for evidence with a view to identifying those ESG rating providers that are currently either present in the EU or located outside but operating in the EU.
4. This call for evidence seeks to develop a picture of the size, structure, resourcing, revenues and product offerings of the different ESG rating providers operating in the EU. ESMA is looking to complement this picture by collecting views and experiences from the users of these ESG rating providers, as well as those entities covered by ESG rating providers.
5. It is anticipated that this consultation from ESMA will be followed by a complementary consultation on this topic from the EC. The latter should seek stakeholder views about the use of ESG ratings by market participants and the functioning and dynamics of the market, potential issues, but also help inform on potential costs of an intervention at EU level.

[\[1\] Action 4c of Annex to the European Commission's Strategy for financing the transition to a sustainable economy.](#)

2. ESG Rating Providers

1. As highlighted in ESMA's correspondence to the EC in January 2021, recent legislative initiatives in the EU have increased financial market participants' needs for information on entities' sustainability characteristics. ESG ratings are just one example of a product that is suited to providing this type of information. However, without regulatory safeguards for these products several issues and risks reduce the potential benefits of these ratings.[1] In addition, a study commissioned by the EC and published in January 2021 identified a lack of transparency of ESG rating providers' operations, a low level of comparability between ESG ratings, and potential conflicts of interest.[2]
2. While 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.
3. Through its participation at IOSCO, ESMA has also been involved in recent work to promote good practices for ESG rating providers, the users of these products as well as entities covered by these providers[3], at a global level. However, despite the valuable information that has been received through these interactions, a comprehensive understanding of the current market structure for ESG rating providers active in the EU has yet to be established.
4. For this purpose, the term "ESG rating provider" is used to refer to entities that develop, offer or provide ESG ratings meeting the description provided on page 3 of this Call for Evidence. In addition, the term "active in the EU" is used to refer to ESG ratings providers who are either, for example, located in the EU, have clients who are based in the EU or who are located outside the EU but provide ESG ratings on entities that are headquartered in the EU.
5. Developing this understanding means establishing a reliable picture of the number, size, business models and product offerings of the different ESG rating providers that are relevant for the EU market.

[1] See ESMA [Report on Trends, Risks and Vulnerabilities, No.1, 2021](#), "ESG ratings: Status and key issues ahead", pp.105-115.

[2] See ERM, [Study on sustainability-related ratings, data and research](#), January 2021.

[3] IOSCO FR09/21 [Environmental, Social and Governance \(ESG\) Ratings and Data Products Providers](#)

3. Users of ESG Ratings

1. In order for ESMA to be able to validate and expand on the information received from ESG rating providers, ESMA is also gathering information from the users of ESG ratings. This information is intended to allow ESMA to understand the different ways in which financial market participants make use of ESG ratings from rating providers who are active in the EU as well as the market dynamics within the industry.
2. The approach of these questions is similar to the section for ESG rating providers. It aims to first establish the legal and regulatory characteristics of those entities contracting with ESG rating providers. It then looks to assess what products they are using and contracting for from ESG rating providers, for which objectives, the nature of the licensing agreements and whether any limitations are placed on the use of this data.
3. On the basis that the business model for providers of ESG ratings is predominantly an investor pays model in the current state of play, clients of ESG rating providers are likely to also be the users of their ESG ratings. However, it is possible that alternative business models exist where the users of an ESG rating providers' products do not have a contractual relationship with the provider, for example in the case of not for profit ESG rating providers. To accommodate these two situations the term "users" in this call for evidence refers to both users who have access to ESG ratings on the basis of a contractual relationship with ESG rating providers as well as those users who use ESG ratings on a non-contractual basis.

4. Entities Covered by ESG Rating Providers

1. In addition to the views of ESG ratings providers and their clients, it is also important to receive information from the entities covered by these providers. Given the predominantly 'investor pays' model of the market for ESG ratings in its current form, it is less common that these entities would have contractual relationships with the entities who are assessing their businesses.
2. Nevertheless, it is important to establish the modalities of these interactions to understand if they pose wider issues for investor protection. For example, the nature of links between ESG rating providers and entities covered could create issues for conflicts of interest management in situations where the rated entity is also a client of the ESG rating provider for other services.

3. The approach of the questions in this section is to build a general picture of whether and how rated entities interact with ESG rating providers active in the EU. In particular, whether their interactions are subject to any contractual agreements and whether there are common problems with the nature, frequency and transparency of these interactions.

5. Next steps

1. Based on the feedback received, ESMA intends to collate the responses to each section and provide the European Commission with an overview of the market for ESG rating providers present or operating in the EU. It is intended that this will be delivered before the end of Q2 2022.

Question Do you agree that your contribution to this survey can be published? Additional help available

For further information please refer to the section "Responding to this Call for Evidence" in the document *Call For Evidence on Market Characteristics for ESG Rating Providers in EU*.

- Answer
Yes
- Answer
No

Question Please select your category:

- Answer
ESG Rating Provider
- Answer
ESG Rating User
- Answer
Entity covered by ESG Rating Providers

1. Background information

Question Q.1 Name of respondent or organisation (including Legal Entity Identifier where applicable).

AIPB – Associazione Italiana Private Banking.

(Italian Private Banking Association).

Question Q.2 Nature of establishment in EU Additional help available

Please explain your answer in the box below

- Answer
(A) Legal entity established in EU (please indicate Member State(s) of legal entities)
- Answer
(B) Legal entity and corporate headquarters established in EU (please indicate Member State for each)
- Answer
(C) No legal entity or corporate headquarters established in EU (please indicate country of corporate headquarters)
- Answer
(D) Other (Please explain)

Question If you answered Q.2, please explain

AIPB represents Private Banking in Italy, an industry dedicated to the protection and investment of family assets.

This industry is developed for clients who want an advanced level of service for the management of their wealth, with high performance expectations.

All national and international players operating in Italy through different business models support the activity of the Association.

Question Q.3 Respondent subject to any existing financial regulatory authorisation, registration or supervisory regime.

- Answer
Yes
- Answer
No

Question If you answered Yes to Q.3, please provide further details of the regime including name of authorisation, registration or supervisory body and reference to supporting legal acts.

Question Q.4 General description of business model and main area of economic activity

Question Q.5 Estimated total value (in EUR) of administrated assets and/or asset under management (if applicable). Additional help available

For currency conversions to EUR, please use ECB reference exchange rates available here:

https://www.ecb.europa.eu/stats/policy_and_exchange_rates/euro_reference_exchange_rates/html/index.en.html

AIPB represents 40 players who manage about 1,000 billion €

Question Q.6 Estimated total value (in EUR) of investments for which ESG rating and/or other ESG data products are used as input in investment decision making process (if applicable).

2. Use of ESG ratings (if applicable)

Question Q.1 Currently contracting for ESG ratings

- Answer
Yes
- Answer
No

Question Q.2 Currently contracting for other ESG data products

- Answer
Yes
- Answer
No

Question Q.3 If you answered "Yes" to Q1 or Q2, please list the providers you contract with for each ESG rating and/or other ESG data products and identify the categories of product.

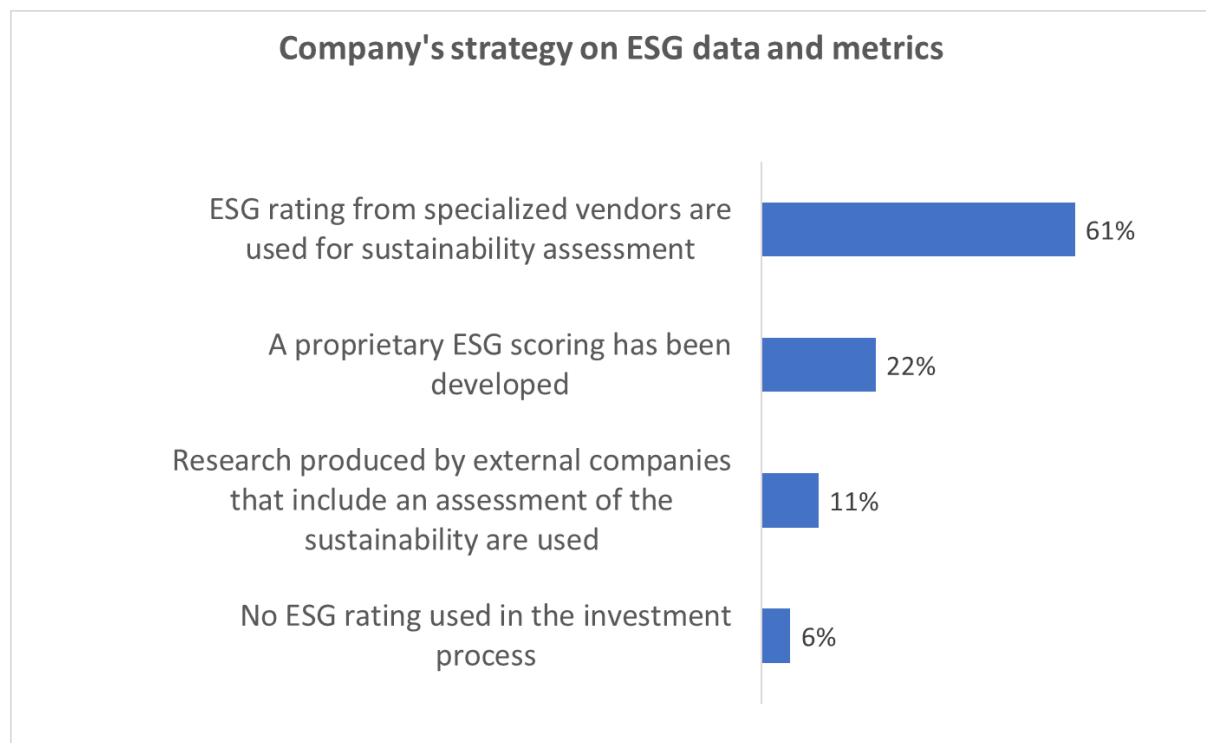
Between July and October 2021, AIPB, in collaboration with Oliver Wyman, carried out a survey aimed at Private Banking players in Italy to map the integration progress of ESG criteria in the investment processes. One of the aspects analyzed concerns of the data and metrics used by players to select sustainable investment products.

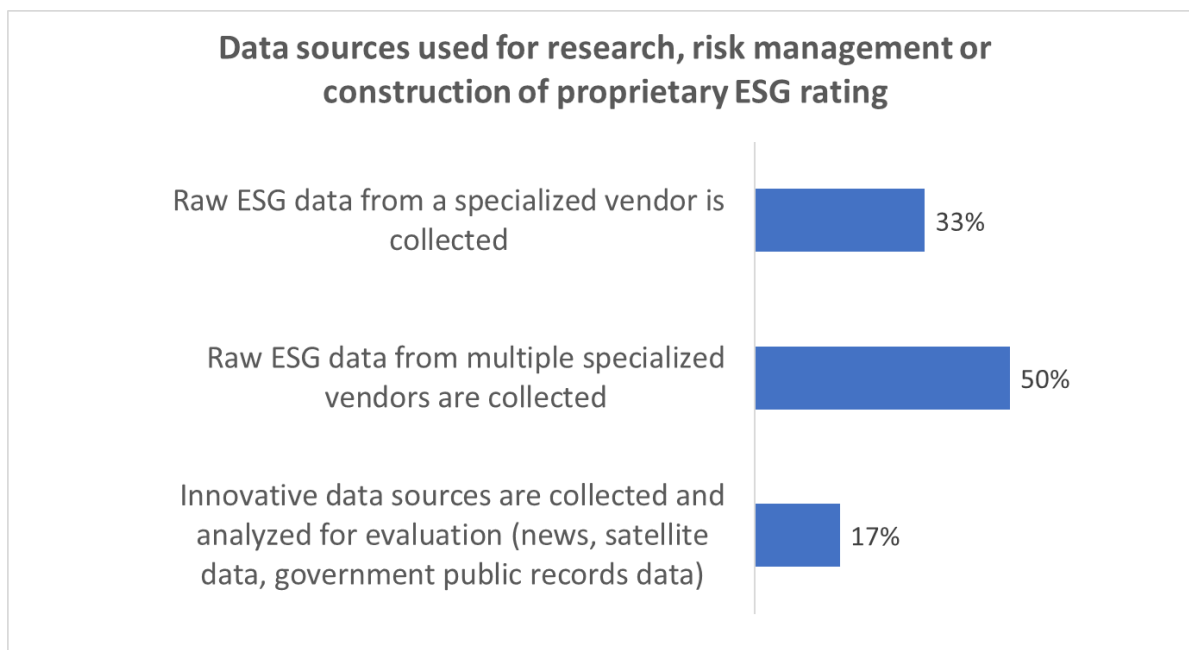
50% of the players (AIPB members) participated in the survey.

94% of players use ESG ratings or scoring within the investment process. 22% of players develop a proprietary rating, while 61% use ratings provided by specialized vendors (eg MSCI, ISS, Sustainalytics, ...). 11% of them choose to use reports provided by specialized external companies. Only 6% of players don't use ESG rating in the investment process.

The use of other information sources was also recorded for research, risk management or for the construction of proprietary scoring.

83% of players collect raw ESG data from one or more specialized providers while 17% collect and analyse innovative data sources.





Question Q.4 Please provide the length of time in months which you have contracted with each provider.

Question Q.5 Please explain reasons behind the choice of the ESG rating or data provider(s) listed in Q3.

Question Q.6 Please explain reasons for choosing more than one ESG rating provider (if applicable).

ESG Ratings from different rating providers have demonstrated to be highly uncorrelated with each other. This suggests the presence of important methodological differences between ESG Rating providers – differently from what we see for financial credit ratings. Given the relative early stage of the market, we see the ESG ratings market more as buy side equity analysis than financial credit ratings. On top of the methodologies, many times also the data input are different since large amount of data are still estimated and there are not standard estimation framework.

Such variety makes no ESG Rating provider “the best” across the board. Each individual investor will value certain elements differently: one element to consider would be the investor’s primary objective, which could be, for example, to have a high number of securities in its portfolio covered by ESG Ratings (i.e. coverage). Another element could be to understand what asset class the investor is focusing the most on. In the case of investment funds, it might be important, for example, to consider not only

the ESG Ratings of the individual holdings in the fund, but also the ESG Rating of the asset management firm and of the fund's ESG strategy.

Question Q.7 In case you changed ESG rating provider, please provide the rationale behind the choice.

Question Q.8 Please outline and explain any shortcomings in the ESG rating or ESG data products you currently contract for.

Some of the pitfalls of ESG Ratings are “reliability”, “subjectivity” and “lack of sufficient coverage”. The first case would imply that ESG Ratings users don't feel comfortable with the methodology used by the ESG Rating provider, or are not confident that the resources used to apply the methodology are able to deliver effectively. On top of that, the methodologies are often complex and there is lack of transparency.

Subjectivity is another major factor in determining the quality of an ESG Ratings provider. In particular, this refers to the extent to which a methodology provides room for subjective judgement, and, consequently how much room is left for human errors. Of course from one side, inserting a relevant component of human judgement could add value, but on the other side could cause divergences and inconsistency.

Last, but not least, “coverage” is often the first element that investors consider when comparing different ESG Rating providers. Coverage is by no means a synonym of quality. Usually, it is actually the contrary since to cover companies that do not actually report/communicate ESG information, a large number of assumptions and estimations are developed, increasing the risk for a mislead evaluation.

However, when too low, it may severely undermine the credibility of an ESG Rating provider.

Question Q.9 Please outline whether you are satisfied with the level of methodological transparency for the products you contract for, including transparency around data sourcing.

Question Q.10 If no to Q.1 and Q.2, please list ESG rating and/or other ESG data products providers you are currently using.

Question Q.11 Please outline and explain any shortcomings in the ESG rating or ESG data products you are currently using on a non-contractual basis.

Question Q.12 Please outline whether you are satisfied with the level of methodological transparency for the products you are currently using on a non-contractual basis.

3. Contractual Characteristics

Question Q.1: If you currently contract for ESG rating or ESG data products, please briefly describe the terms of use of your ESG rating provider, including:

Time horizon of the contract:

- Please provide details of break clauses and frequency of renewal.

Question Products included in contract:

- Please outline if the contract covers a single product offering or a package of product offerings.
- Please outline if products were available only under the form of packages of multiple service and/or products.
- Please provide a more specific description of the products including their intended area of focus.

Question The fees structure for contracted products:

- Please outline if there is a flat fee for each product offering, or discount for bundled offerings.
- Please outline the main characteristics of the fee structure, including frequency and transparency of revisions.

Question Any usage limitations (e.g. use of ratings, access to ESG ratings, time restrictions, others):

- Please outline if there are any usage limitations placed on the products which are contracted for, for example, ability to disclose or share with third parties.

4. General views on ESG ratings in EU Financial Markets

Question Q.1 Please provide your views on the level of relevance of ESG ratings to EU financial markets and financial market participants. Do you consider this level will increase in the coming years?

The main role that ESG Ratings play in EU financial markets is to enable investors to understand the ESG risks in their portfolios, and to assist companies (that are rated) in understanding which ESG issue is more material for them to tackle at each moment in time. ESG Ratings are also important tools to limit “greenwashing”. In order for that to happen, it is important to have a certain degree of variety in ESG Ratings methodologies and approaches, which would more effectively assist investors in making informed and rational choices.

Question Q.2 Please provide your views on the level of risk ESG ratings currently pose to orderly markets, financial stability and investor protection in the EU. Do you consider this level will increase in the coming years?

Stability of the financial markets and ESG Ratings are related on a number of ways and will be more and more connected. Reliance of the financial industry on just a few ESG Rating providers may create a concentration risk, on top of conflict of interests problems, which ultimately may prompt sudden shifts in financial flows once a rating is changed by a single ESG Rating provider. This phenomenon would resemble the one that we observe when financial credit ratings are changed. Similarly to financial credit ratings, disinvestment after an ESG Rating downgrade is increasingly driven by responsible investment policies, that often leave no chance to the investors than to liquidate a position once a rating is changed.

The stability of the financial markets may also be hampered by ESG Ratings methodologies that are now fully accounting for all “ESG risk” of the stock, bond or fund analysed. Effective management of ESG risk would eventually reduce the occurrence of events of “panic-selling” from investors, that may arise from sudden ESG Rating revisions due to unexpected negative ESG events.

A sound methodology should also strike the balance between revisions of ESG Ratings that are too frequent and revisions that are too rare. The more frequent a rating is revised, the more likely that the rating is punctual at any point in time. However, with frequent updates, investors may also

be forced to buying and selling of securities very often, which increases transaction costs and ultimately decreases the overall efficiency of the financial system.