CONSULTATION RESPONSE

SEBI - CONSULTATION ON ENVIRONMENTAL, SOCIAL AND GOVERNANCE (ESG) RATING PROVIDERS FOR SECURITIES MARKETS

10 March 2022

INTRODUCTION

The Principles for Responsible Investment (PRI) is the world's leading initiative on responsible investment. The PRI is a not-for-profit company with over 4,700 signatories (pension funds, insurers, investment managers and service providers) to the PRI's six principles, with approximately US $121 trillion in assets under management.

The PRI supports its international network of signatories in implementing the Principles. As long-term investors acting in the best interests of their beneficiaries and clients, our signatories work to understand the contribution that environmental, social and governance (ESG) factors make to investment performance, the role that investment plays in broader financial markets and the impact that those investments have on the environment and society as a whole.

The PRI works to achieve this sustainable global financial system by encouraging adoption of the Principles and collaboration on their implementation; by fostering good governance, integrity and accountability; and by addressing obstacles to a sustainable financial system that lie within market practices, structures and regulation.

The PRI welcomes the opportunity to respond to the Securities and Exchange Board of India (SEBI) consultation paper on environmental, social and governance (ESG) rating providers for securities markets (Consultation Paper).

ABOUT THIS CONSULTATION

On 24 January 2022, SEBI published a Consultation Paper on environmental, social and governance (ESG) rating providers for securities markets. The Consultation Paper seeks public comments on a proposed regulatory framework to regulate ESG rating providers (ERPs), including in relation to oversight and periodic disclosure requirements. The consultation paper follows a series of discussions held with multiple stakeholders, including global and national ERPs, credit rating agencies (CRAs), mutual funds offering ESG schemes, and research/ audit firms.

In the Consultation Paper, SEBI proposes to accredit ERPs for the purpose of assigning ESG ratings to listed entities and listed securities. It also sets out details of regulations and requirements that would apply to such accredited entities.

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KEY RECOMMENDATIONS

The PRI welcomes increased attention by regulators such as SEBI to the market for ESG ratings and data products and the providers of these products, given the important role these products play in investment processes. The market for ESG ratings and data has experienced considerable growth and consolidation in recent years. Demand for these products and services is only likely to keep growing in the future, given investors' accelerating interest in ESG and sustainable investing and as they increasingly face mandatory ESG disclosure requirements[1].

In light of these developments, supervisory authorities should consider regulatory action to enhance the functioning of the market for ESG ratings and data products. The PRI recommends that regulators focus their attention on:

- Improving transparency by ESG ratings and data products providers on their methodologies and processes, by developing minimum quality and transparency standards, and ensuring that data coverage gaps and biases are addressed.
- Ensuring that ESG ratings and data products providers have appropriate governance arrangements in place, that offered products and services are free of conflict of interest or other undue influences (with greater clarity on whether and how the rated issuer perspective is included into the rating and engaged by the provider).

The PRI is therefore generally supportive of SEBI's proposals to accredit ERPs in relation to their activities in India. In doing so, any accreditation or regulatory requirements should be balanced and proportionate and allow for market innovation when it comes to rating methodologies, without being prescriptive about the methodologies themselves.

In addition, the PRI recommends accelerating the reforms towards mandating corporate reporting standards and disclosures of key underlying ESG data. We welcome global and regional efforts by regulators to improve the reliability, consistency, and comparability of corporate ESG reporting standards and disclosures. These efforts are crucial to increase the availability and quality of ESG data, and by extension the quality of ESG ratings and data products.

The PRI acknowledges that investors have the responsibility to understand the intended purposes and the methodologies of ESG ratings and data products and should determine whether these are suitable for the purpose for which they are being used in the investment process.

DETAILED RESPONSE

3.6. Views/ comments sought on:

a) Whether there is a need to regulate/accredit ERPs in securities market?

b) If ESG ratings are to be regulated, is the regulatory scope mentioned above adequate? If not, please suggest requisite modifications.

[1] According to a position paper by the AFM and AMF, the ESG data and services market could reach a value of over US$5 billion by 2025 (Position Paper: Call for a European Regulation for the provision of ESG data, ratings, and related services).

PRI Response

The PRI supports increased attention by regulators such as SEBI to the market for ESG ratings and data products and the providers of these products, and notes the findings in the recent IOSCO report[2] on ESG ratings and data products providers. The strong growth of responsible investment practices has led to a steep increase in the demand for ESG data and related products and services. Almost all investors now use third party providers for obtaining at least some of their ESG data and analysis, and some investors even rely on externally processed data and other resources like ESG scores.[3]

Although large investors are increasingly developing in-house metrics to better capture ESG risks and opportunities and sustainability performance within their investment processes, third-party providers will continue to play an important role by providing more tailored services, such as data modelling and analytics, and bespoke data feeds. As intermediaries between corporates and investors, they are an essential component of the sustainable investment chain, and the PRI believes their relevance to financial market participants will continue to increase due to the increased use of ESG ratings by both active and passive investment portfolios.

Investors holding active portfolios are likely to continue to rely on ESG ratings in the coming years to assess their portfolio selections and make informed decisions regarding their voting and engagement practices. However, there is also an increasing reliance on ESG ratings in passive portfolios. ESG ratings play a critical role in the methodology of a considerable proportion of these assets, predominantly through their impact on the exclusions and weightings assigned to companies in ESG-themed passive equity, and to a lesser extent fixed income, indices. Given the substantial and growing impact that ESG ratings have on investment allocations, the integrity of these ratings is paramount.

For these reasons, the PRI is generally supportive of SEBI's proposals to accredit ERPs in relation to their activities in India. In doing so, any accreditation or regulatory requirements should be balanced and proportionate and allow for market innovation when it comes to rating methodologies, without being prescriptive about the methodologies themselves.

4.3. Views/ comments sought on:

a) Should only CRAs and RAs be considered to accredit as ERPs?

b) Could any additional category of entities be specified as an entity eligible for accreditation as an ERPs along-with rational for the same?

No PRI response.

5.7. Views/ comments sought on:

a) Whether the above accreditation criteria, including net worth, are appropriate?

b) Please offer comments on whether any additional conditions/requirements need to be specified, if any?

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[2] IOSCO 'Environmental, Social and Governance (ESG) Ratings and Data Products Providers' FR09/2021 Environmental, Social and Governance (ESG) Ratings and Data Products Providers (iosco.org)

[3] See, for example, p.3 of the results from a PRI survey for fixed income investors on ESG information providers Broadening the outreach to ESG information providers | Article | PRI (unpri.org)

No PRI response.

6.7. Views/ comments sought on:

a) Whether the above proposal on classification of ESG ratings and other related products is appropriate?

PRI Response

Investors need to be able to understand an ESG rating's or data product's intended purpose and how its outputs are determined, to choose the product that best fits with their investment processes. In this context, investors have indicated that providers should improve their communication in the event of changes to data or methodology, for example by organising consultations or providing ad hoc updates. In addition, improved transparency would not only help investors, but also make ESG ratings and data products providers more accountable for how they verify and validate their data sources and metrics, including to regulators. This in turn can help to increase the reliability and quality of ESG ratings and data products.

If the underlying methodologies of the products are well explained and communicated, and the data sources are clear, investors can choose the offerings that best meet their investment processes. For example, some ESG ratings try to capture an issuer's exposure to ESG risks and how prepared they are to manage these risks, while others assess the positive and negative impact of companies on the environment and society, irrespective of whether such factors have any impact on the company's enterprise value. ERPs are currently not always clear about the objectives of their ratings, what their methodologies are or what data they use. How they make such assessments should be better explained. This should also help the market better understand the reasons behind divergent ESG ratings from different providers.

The PRI therefore supports requirements that ERPs should transparently disclose and communicate their objectives, methodologies and data sources for any ratings that they are providing.

7.5. Views/ comments sought on:

a) Whether the proposal on not having standardized ESG rating scales (i.e., standardized symbols and their definitions) initially is appropriate?

As noted above, the PRI takes the view that regulatory interventions should be proportional and allow for market innovation when it comes to rating methodologies, without interfering with the methodologies themselves. The PRI therefore supports the proposal on not having standardized ESG rating scales initially.

10.9. Views/ comments sought on:

a) Whether the proposed norms relating to transparency, governance and conflict-of-interest issues in the ESG rating process are appropriate?

b) Whether ERPs should be free to assign ESG ratings on a sector specific or sector-agnostic basis, subject to adequate disclosures on the same?

PRI Response

As noted above, the PRI considers that improvements in transparency and governance of ERPs and the products they provide are of critical importance to investors that are seeking to rely on them.

Transparency of methodologies:

- to enable investors to understand the underlying nature and basis of the ESG information – either in terms of the underlying data set and/or the methodology used to arrive at the evaluation or opinion – providers should disclose and clearly signpost data sources, distinguishing between whether an issuer's information is public (either voluntary or mandatory) or generated by internal models and assumptions, and whether those are AI or non-AI derived. Investors also need more information on how data is updated, for example when data sources are discontinued, or historical data is revised.
- Enhanced transparency of methodologies will also ensure that investors applying ESG ratings to different asset classes are able to undertake analysis on the appropriateness of the rating for use in their particular investment strategy and/or analytical model. ESG-focused data, products and services have historically been tailored to meet the needs of equity investors. PRI research[4] highlighted that fixed income investors utilise ESG ratings and data differently to equity investors, recommending that further transparency and customisation of methodologies is required to properly accommodate this market. The PRI's ongoing work in this area also notes ongoing confusion by market participants regarding what is measured by ESG ratings versus credit ratings.[5] Enhancing transparency of methodologies is an important step towards addressing such issues. Furthermore, even for those investors that carry out proprietary ESG assessments, it is important to have transparent methodologies for all ESG ratings' providers so they can justify to clients why and where assessments may differ from third party providers' ratings.

Governance and conflicts of interest:

- To ensure the reliability of ESG ratings and data products, providers of these products should have adequate governance arrangements in place to identify, manage and mitigate any potential conflicts of interests that may occur because of the organisational structure of the provider, fee structures or intersecting business activities. Especially for ESG ratings, investors need to have assurance that an evaluation of a given company was not unduly influenced, for example due to the fee model ('issuer pays') or consulting services provided to that company by the same provider. The PRI notes ESMA's[6] concerns regarding the conflicts-of-interest that may exist in traditional business models, such as credit ratings agencies, which are now offering ESG-related products and services. However, if proper governance mechanisms are put in place to ensure a separation of complementary business activities, these risks may diminish.

11.9. Views/ comments sought on: a) Whether you agree with the recommendation that the payment model should be subscriber pay in the current Indian context?

No PRI response

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[4] PRI research 'Do ESG information providers meet the needs of fixed income investors?' Do ESG information providers meet the needs of fixed income investors? | Article | PRI (unpri.org)

[5] PRI 'Statement on ESG in credit risk and ratings' Statement on ESG in credit risk and ratings (available in different languages) | PRI Web Page | PRI (unpri.org)

[6] ESMA 'ESMA finds high level of divergence in disclosure of ESG factors in credit ratings' ESMA finds high level of divergence in disclosure of ESG factors in credit ratings (europa.eu)