CONSULTATION RESPONSE

EUROPEAN COMMISSION CONSULTATION ON THE FUNCTIONING OF THE ESG RATINGS MARKET IN THE EU AND ON THE CONSIDERATION OF ESG FACTORS IN CREDIT RATINGS

3 June 2022

This consultation response represents the view of the PRI Association and not necessarily the views of its individual members.

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 European Commission consultation on the ESG ratings market and how credit rating agencies incorporate ESG risks.

ABOUT THIS CONSULTATION

The European Commission has launched a public consultation to better understand the functioning of the ESG ratings market and how credit rating agencies incorporate ESG risks. Responses will feed into an impact assessment and could lead to a possible legislative initiative on ESG ratings and on sustainability factors in credit ratings.

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KEY RECOMMENDATIONS

ESG Ratings

The PRI welcomes increased attention by regulators such as the European Commission to the market for ESG ratings and data products and the providers of these products, given the role these products play in investment processes. ESG information providers – referring to third party providers of ESG data, services, opinions, research and/or ratings – offer an important service to investors, and this market 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, the Commission should consider regulatory action to enhance the functioning of the market for ESG ratings and data products. The PRI recommends focusing attention on the following:

- Improving transparency by ESG information providers on their methodologies and processes, by developing minimum quality and transparency standards, and ensuring that data coverage gaps are disclosed and reduced where possible. In addition, regulators should consider improving transparency on pricing policies.
- Ensuring that ESG information providers have appropriate governance arrangements in place, that they have rigorous conflicts of interest management policies and that they prioritise the independence and integrity of their research and offerings.

However, any reforms should be proportionate and allow for market innovation. We encourage the Commission and supervisors to continue to work with investors and providers to determine an appropriate approach.

In addition, the PRI recommends accelerating the reforms towards mandating corporate reporting standards and disclosures of key underlying ESG data. These efforts are crucial to increase the availability and quality of ESG data, and by extension the quality of ESG ratings and data products, as both investors and providers need decision-useful, timely and standardised corporate disclosure. In this context, we welcome global and regional efforts by regulators to improve the reliability, consistency, and comparability of corporate ESG reporting standards and disclosures.

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.

[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).

ESG in credit ratings

As part of the ESG in credit risk and ratings initiative, the PRI has been engaging with fixed income investors and credit rating agencies since 2016 to enhance the systematic and transparent incorporation of ESG factors in credit risk analysis. Overall, the 27 credit rating agencies that are supporting this initiative have made progress in signposting the impact of ESG issues in their analyses and ratings. They have published notes explaining how they incorporate ESG factors into their methodologies, and ESG-related research has grown rapidly. They have built dedicated ESG teams and have expanded resources and analytical tools. And, most importantly, signposting and transparency of how ESG factors contribute to credit rating opinions, when relevant, and how they feature in the assessment methodologies has improved significantly, partly also as a result of ESMA guidelines.

However, progress remains uneven across CRAs, depending on their size and resources. Also, many CRAs have started producing non-credit scores/ratings. Whilst this is in part the result of their effort to make more explicit how ESG factors impact credit rating opinions, the distinction between credit and non-credit ratings has become more blurred, even if the two types of products are developed by different part of the CRA corporate entities. Therefore, more clarity is needed. Finally, the issue of the time horizons and how to assess ESG risks that may affect credit rating opinions beyond the 'typical' credit rating time horizon remains an area that needs attention. Credit rating opinions are based on forecasts and the further out these extend into the future, the more uncertain they become. Nevertheless, although many ESG factors are linked to long-term trends, adjusting to the latter may require changes to business or growth models with credit-quality implications that are near- or medium term (e.g. the costs associated to shift to electric vehicle production in the automotive industry or to plant-based solutions in the food industry). Hence, further detailing of ESMA guidelines on how CRAs should extend the forward-looking component of their credit-opinions would be welcome.

DETAILED RESPONSE

PART A – ESG RATINGS

Background information

See consultation document (page 4).

Use of ESG ratings and dynamics of the market

The study identified a rapid growth in global assets committed to sustainable and responsible investment strategies over the last decade, which is forecast to continue as sustainable investing becomes fully integrated into asset management. This leads to higher demand by investors for ESG ratings to help them decide on particular investment strategies.

The study identified two key trends over the past five years - being consolidation and reinforcement of the established ESG ratings providers, and growth in the overall number of providers due to new market entrants.

The study also highlighted that it is challenging for new market entrants to replicate and compete with the larger providers due to high initial level of investment needed to cover a broad range of ESG issues, with as many as a thousand data points, across thousands of companies.

3. Questions for all respondents

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

- **Yes**
- No
- Don't know / no opinion / not applicable

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)?

- **Growth in demand from investors in ratings of companies for their investment decisions [9]**
- **Growth in demand from companies in ratings including on rating future strategies [7]**
- **Further standardisation of information disclosed by companies and other market participants [9]**
- **Other**

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

ESG information providers – referring to third party providers of ESG data, services, opinions, research and/or ratings – offer an important service to investors. The information they provide enables investors to understand, measure and manage ESG risk and opportunity. In that way, they are a valuable addition to investors' portfolio analysis and investment decision-making.

The market for ESG information has experienced considerable growth and consolidation in recent years[2]. Demand for these products and services is 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[3].

Although large investors are increasingly developing in-house metrics to better capture ESG risks and opportunities and sustainability performance within their investment processes, ESG information 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 EU financial market and financial market participants will continue to grow due to the increased use of ESG ratings by both active and passive investment portfolios.

Investors holding active portfolios are likely to continue using ESG ratings in the coming years to assess their portfolio selections and make informed decisions regarding their voting and engagement practices. However, passive portfolios also increasingly use ESG ratings. Following on from year-on-year growth since 2005, the EU is the largest market for ESG or sustainability focused passive investments, representing more than 75% of global assets in this category in 2020[4]. ESG ratings play a key role for a considerable portion 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.

Considering these developments, the PRI welcomes the increased attention from the European Commission and regulators such as ESMA[5] and IOSCO[6] to the ESG information providers' market, given the important role these products play in investment processes. The PRI is carrying out its own research into the ESG information providers' market, with a particular focus on investor climate data needs, and looks forward to further contributing to the discussion.

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

- Yes
- **No**
- Don't know / no opinion / not applicable

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[2]According to research by Opimas, the global market for ESG data surpassed US$1bn for the first time in 2021. With a 28% annual growth rate over the past five years, the market could exceed US$1.3bn by 2022. The research found that the growth stems, in part, from increasing demand for funds that incorporate ESG risks into their investment strategies, but also from the emergence of new regulatory requirements around ESG reporting and disclosure. 'ESG data is now worth it, Opimas, 19 April 2022, ESG Data is Now Worth it (opimas.com)

[3] 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.

[4] 'Passive Sustainable Funds: The Global Landscape 2020', Morningstar, September 2020, p.10.

[5] See the PRI's response to ESMA's call for evidence on market characteristics for ESG rating providers in the EU

[6] See the PRI's response to IOSCO's consultation on ESG ratings and data products providers

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

The PRI believes that investors or other users of ESG information products such as research, should ensure they understand the data sources behind the product and determine whether it is suitable for their investment processes, by carrying out comprehensive due diligence. Ultimately, investors decide on what ESG information and analysis is incorporated in their investment decisions and therefore bear the responsibility to ensure that any ESG information they use is fit for purpose for their investment processes.

However, this is also contingent on increased transparency by ESG information providers on the methodologies of their products (including data sources) to enable investors to conduct this due diligence in full. In the PRI’s view, this level of consistent transparency is not yet offered by ESG information products, thus limiting the ability of investors to carry out sufficient due diligence (more detailed information is available later in this response).

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?

The PRI does not believe that ESG information products, including research products, have reached a sufficient level of maturity and comparability to allow investors to optimally select and understand the products they use. This is for the following reasons:

- **The availability of reliable, high-quality, and up to date ESG data** is a critical component of ESG information products and determines to a large extent the quality of the products and their comparability. Therefore, the lack of reliable, consistent, and comparable ESG reporting standards and poor disclosures from issuers, impacts not only the availability and quality of information that can be used by investors, but also by ESG information providers. Current global efforts, led by the International Reporting Standards Foundation (IFRS) to establish a global baseline for corporate sustainability reporting focussed on enterprise value creation, and regional developments that introduce or expand corporate ESG standards and disclosure requirements such as the EU’s Corporate Sustainability Reporting Directive, can help to address this issue, and are particularly welcome.
- **Transparency of methodologies:** investors need to be able to understand an ESG information product’s intended purpose and how its outputs are determined, to choose the product that best fits with their investment processes. In addition, improved transparency would not only help investors, but also make ESG information 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 information products. However, investors have indicated that ESG information providers’ methodologies are not yet sufficiently transparent to enable them to fully compare ESG information products during their due diligence processes and in their subsequent usage. This is for a number of reasons including: poor client communications – for instance in the

event of changes to data or methodology, and a lack of transparency over data sources, verification and validation (which will be explored in more detail later in this response).

Functioning of the ESG ratings market

The study identified several issues on the functioning of the ESG ratings market that may hamper its further development. In particular, there is an overall demand for greater transparency of objectives sought, methodologies adopted and quality assurance processes in place ESG rating providers.

The timeliness, accuracy and reliability of the output from ESG ratings providers were also identified as issues for the good functioning of this market. Another issue identified in the study concerns the existence of biases and low correlation across ESG ratings.

The potential for conflicts of interest, particularly associated with providers both evaluating companies and offering paid advisory services, was further highlighted. The study stressed that providers selling multiple products require an appropriate separation between departments to avoid potential conflicts of interest.

This section aims to inform on the functioning of the ESG ratings market and potential issues that hamper its development and trust by market participants.

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

- Well
- **Not well**
- Please explain why:

The market for ESG ratings and data has experienced considerable growth and consolidation in recent years, alongside growing demand for these products and services which play an important role in investor decision-making. However, the PRI does not believe the market is functioning optimally and notes the following areas for attention:

- Transparency of methodologies.
- Coverage of markets and types of issuers.
- Governance and conflicts of interest.

In addition, it should be recognised the availability of reliable, high-quality, comparable corporate ESG data is a key condition for the development of and trust in the ESG ratings market and needs be addressed urgently.

These points are addressed in more detail throughout this response.

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)?

- **Lack of transparency on the operations of the providers [7]**
- **Lack of transparency on the methodologies used by the providers [9]**
- **Lack of clear explanation of what individual ESG ratings measure [8]**

- **Lack of common definition of ESG ratings [8]**
- **Variety of terminologies used for the same products [6]**
- **Lack of comparability between the products offered [6]**
- **Lack of reliability of the ratings [8]**
- **Potential conflicts of interests [9]**
- **Lack of supervision and enforcement over the functioning of this market [9]**
- **Other**

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

In addition to the points raised above, the PRI believes that ESG information providers should acknowledge that high quality ESG data reflects more readily available information in the investment-grade and developed markets. For instance, a recent PRI report on emerging markets found that ESG data for emerging markets is often lacking due to both weak or non-existent disclosure requirements and poor coverage by most major information providers, among other factors.[7] Consequently, providers should consider, where possible, reducing data coverage gaps by increasing and adapting the coverage of emerging markets and non-listed issuers and instruments (e.g. private and sovereign issuers, securitised debt) in their products, subject to full transparency on data sources and methodologies[8].

What do you think of the quality of the ratings offered on a scale from 1 (very poor) to 10 (very good)? **[6]**

- Please explain why.

The availability of reliable, high-quality, and up to date ESG data is a critical component of ESG information products and determines to a large extent the quality of the products and their comparability. Therefore, the lack of reliable, consistent, and comparable reporting standards, when combined with poor disclosures from issuers, has impacted not only the availability and quality of information that can be used by investors, but also by ESG information providers.

As set out in the responses above, the PRI believes the following issues should be addressed to improve the functioning of the ESG information market and the quality of the ratings offered:

- Transparency of methodologies.
- Coverage of markets and types of issuers.
- Governance and conflicts of interest.

[7] See the PRI's report 'Closing the funding gap: the case for ESG incorporation and investing with sustainability outcomes in emerging markets', download (unpri.org), p.15.

[8] 'The unintended consequences of sovereign ESG benchmarks', Jeroen Verleun The unintended consequences of sovereign ESG benchmarks | Responsible Investor (responsible-investor.com)

In addition, it should be recognised the availability of reliable, high-quality, comparable corporate ESG data is a key condition for the development of and trust in the ESG ratings market and needs be addressed urgently.

These points are considered in more detail throughout this response.

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)? Answer (scale 1 to 10)

- Please explain why.

N/A

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

Biases based on the type of ownership of the company (publicly listed, privately-owned, family-owned etc.)

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

- Yes
- **No**
- No opinion

Please explain your answer.

The PRI does not believe a lack of correlation (or diverging ratings) is detrimental in itself, despite a high level of divergence between ESG ratings[9] assessing the same sustainability aspects. This divergence can be for a number of reasons, for instance where the PRI has found a high level of measurement divergence in 'E' factors amongst large market capitalisation companies, it can be

[9] IOSCO 'Environmental, Social and Governance (ESG) Ratings and Data Products Providers' https://www.iosco.org/library/pubdocs/pdf/IOSCOPD690.pdf, p.19.

the case that corporate performance on different ‘E’ factors varies. However, it has also led to concerns that ESG ratings providers, who also conduct business in investment analysis or index provision, may be unduly incentivised to produce ESG products that boast both strong ratings and market outperformance[10]. Therefore, there is a need to ensure that ESG ratings divergence is not a result of conflicts of interest.

Nevertheless, it is the responsibility of investors or other users of ESG information products to ensure they understand the intended purpose and methodology of the product and determine whether it is suitable for their processes by carrying out comprehensive due diligence. This process would be facilitated by increased transparency of the methodologies used by data providers, so investors can understand why the data diverges, compare them on that basis, and make informed decisions about the data sets they're using in their investment processes.

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)?

Please explain your answer.

N/A

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)

- **There is a lack of transparency on the methodology and objectives of the respective ratings [9]**
- **The providers do not communicate and disclose the relevant underlying information [9]**
- **The providers use very different methodologies [9]**
- **ESG ratings have different objectives (they assess different sustainability aspects) [6]**
- Other issue(s)

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

N/A

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:

[10] ‘Is History Repeating itself? The (un)predictable past of ESG ratings, Florian Berg, Komelia Fabisik and Zacharia Sautner, August 2021’

ESG information products play an important role in investment decision-making and investors will continue to rely on their services to assess different sustainability aspects affecting their businesses. A range of ESG ratings – assessing different sustainability aspects – is of benefit to investors and the wider market, to support them with their evolving ESG strategies and give them a choice of provider that is aligned with their ESG investment objectives. However, it is important that any ratings provided should ensure their methodologies and underlying data sources, are transparent, reliable, and well-communicated (within the limits of what they can reasonably share), to allow end users to make informed decisions about the data sets they're considering using.

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]**?

Please explain your answer:

To ensure the reliability of ESG information products, providers of these products should have adequate governance arrangements in place to identify, manage and mitigate any potential conflicts of interest 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. In the PRI's view, governance arrangements should be mandatory and designed to ensure the independence of the research and absence of any undue influence, including from researched or rated entities.

Furthermore, the PRI notes ESMA's[11] 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.

If you consider that this market is very much prone to conflicts of interest, where do you see the main risks? (select as many as you like)

- **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

[11] 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)

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

N/A

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]**

Please explain your answer:

> There has been a high level of consolidation within the ESG ratings market in recent years[12]. As detailed within IOSCO's November 2021 report[13], small ESG information providers operate alongside larger, international providers (many of which are continuing to expand by acquiring smaller, specialist companies). They are complemented by a range of fin-tech and start-up companies, which may offer services linked to big data or artificial intelligence.
>
> Sustainable markets are at the heart of the PRI's Blueprint for Responsible Investment and its 2021-2024 strategy[14]. As such, the PRI welcomes economically efficient and sustainable markets which benefit from a competitive range of market participants. The PRI is therefore supportive of initiatives to reduce barriers to new market entrants, such as smaller ESG information providers, to encourage the development of a well-functioning ESG information market and provide investors with a choice of the high quality, reliable and comparable data they need to make their investment decisions.

What barriers do you see for smaller providers?

> In the PRI's view, there are a number of barriers to entry for small providers. These include:
>
> - The lack of high-quality, consistent, and comparable data from issuers causes challenges for smaller providers and new entrants, which must divert some of their more limited resources to interpreting the data they receive, filling any data gaps and verifying the quality of the products they're using. For this reason, the PRI is supportive of global efforts, and regional developments, that introduce or expand corporate ESG standards and disclosure requirements (as set out above).
> - Changing regulatory environment. According to the IOSCO report[15], smaller providers often ‘have a specific regional presence and/or specialisation in specific data sets’ or they may be start-ups or fin-techs which ‘usually focus on using and leveraging big data and artificial intelligence in their product offerings’. Many will rely on limited resources to seek and

[12] See figure 1 on the PRI's website: Do ESG information providers meet the needs of fixed income investors? | Article | PRI (unpri.org) and IOSCO 'Environmental, Social and Governance (ESG) Ratings and Data Products Providers' https://www.iosco.org/library/pubdocs/pdf/IOSCOPD690.pdf, p.12

[13] IOSCO 'Environmental, Social and Governance (ESG) Ratings and Data Products Providers' https://www.iosco.org/library/pubdocs/pdf/IOSCOPD690.pdf, p.12

[14] PRI Blueprint for Responsible Investment A blueprint for responsible investment | PRI Web Page | PRI (unpri.org) and 2021-2024 strategic plan download (unpri.org)

[15] IOSCO 'Environmental, Social and Governance (ESG) Ratings and Data Products Providers' https://www.iosco.org/library/pubdocs/pdf/IOSCOPD690.pdf, p.12

interpret data from a wide range of sources, then report on ESG ratings and, following on from the point above, will be reliant on the quality of the data they source and the underpinning regulatory environment. Given the increasing regulatory attention from regulators such as ESMA and IOSCO, and the interest from the European Commission, providers are increasingly aware that regulatory developments may be forthcoming. This regulatory uncertainty leads to challenges for smaller providers in their business planning processes and could make it harder to determine their competitive advantage. However, the PRI notes the proposal for a European Single Access Point (ESAP) which should facilitate access to ESG data and benefit smaller providers and investors alike.

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)?

Please explain your answer:

See response above.

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.

The 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:

Given the importance of ESG information providers in investment processes and following recent growth and consolidation in the market and the issues identified within this response, the PRI is supportive of an EU legislative intervention in the market (as part of a wider sustainable finance policy framework[16]).

The PRI recommends that the intervention should focus on the following:

[16] PRI, World Bank: How policy makers can implement reforms for a sustainable financial system (2020) How policy makers can implement reforms for a sustainable financial system | Thought leadership | PRI (unpri.org)

- Improving transparency by ESG information providers on their methodologies and processes, by developing minimum quality and transparency standards, and ensuring that data coverage gaps are addressed.
- Ensuring that ESG information providers have appropriate governance arrangements in place, that they have rigorous conflicts of interest management policies and that they prioritise the independence and integrity of their research and offerings. For ESG ratings, this includes full transparency on whether and how the rated issuer is engaged by the provider and to what extent its perspective is included in the rating.

However, any reforms should be proportionate and allow for market innovation. They could also draw on past and existing voluntary standards for responsible investment research, such as ARISTA[17]. The PRI encourages the Commission to continue to work with investors and ESG information providers to determine an appropriate approach, which takes into account relevant existing or proposed regulatory initiatives.

For instance, the PRI notes the relevance of ESG ratings to the EU's Sustainable Financial Disclosure Regulation (SFDR). Specifically, SFDR Articles 8 and 9 will require investors to disclose how products pursuing ESG or sustainability objectives align to those objectives[18]. In ESG-themed index products, for example, ESG ratings feature in the methodology of the benchmark and inform the ongoing assessment of the companies and issuers included. So, investors will rely on the accuracy of ESG ratings to evidence alignment with ESG objectives within these products.

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**

Please explain your answer:

As ESG information products play such an important role in investment decision-making, it is paramount that these products are reliable, high quality and transparent. Consequently, the PRI believes the EU should introduce a legislative intervention that focuses on these issues (as set out in more detail above): improving transparency by ESG information providers on their methodologies and processes, by developing minimum quality and transparency standards, and ensuring that data coverage gaps are disclosed and reduced where possible; and by ensuring that ESG information providers have appropriate governance and conflicts of interest arrangements in place.

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

[17] ARISTA is the Responsible Investment Research Standard, developed in response to the demands from global investors and companies for responsible investment (RI) research groups to incorporate the key principles of quality, integrity, transparency and accountability into their research processes: 2012_Press_release_ARISTA_3_0.pdf (vigeo-eiris.com)

[18] PRI report 'EU regulation on sustainability-related disclosures in the financial services sector' [EU Regulation on sustainability-related disclosures in the financial services sector | Policy report | PRI (unpri.org)]

legislators and 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, as both investors and providers need decision-useful, timely and standardised corporate disclosures.

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).

Please specify the other elements the intervention should focus on and explain what solutions and options you would consider appropriate:

N/A

Please explain what solutions and options you would consider appropriate in order to improve transparency on the operations of providers:

It is important that ESG information providers are transparent about the services they provide. From an operational perspective, and in so far as it concerns managing potential conflicts of interest, in the PRI's view, providers should ensure they have appropriate governance arrangements in place and that offered products and services are free of conflict of interest or other undue influences. This is particularly important for ESG ratings or scores (as well as rankings), where the interplay with other services offered by the same provider could create conflicts of interests. Such governance requirements should go beyond a best effort basis and be elevated to mandatory requirements for ESG information products and their providers. Further detail is set out below in response to the conflicts of interest point.

Please explain what solutions and options you would consider appropriate in order to improve transparency on the methodology used by providers:

As set out in our responses above, investors need to be able to understand an ESG information product's intended purpose and how its outputs are determined, to choose the product that best fits with their investment processes. In this context, transparent and well-communicated methodologies (to the extent that they're able to) are critical for supporting investors with these choices – including when changes are made to the underlying data or to the methodologies themselves[19]. In addition, improved transparency would not only help investors, but also make ESG information providers more accountable for how they verify and validate their data sources and metrics, including to regulators. This in turn could help increase the reliability and quality of ESG information products.

Furthermore, 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.

If the underlying methodologies of the products are well explained and communicated (to the extent that they're able to), 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 – how ESG ratings providers make such assessments should be better explained. This should also help the market better understand the reasons behind divergent ESG ratings from different providers.

Enhanced transparency of methodologies will also ensure that investors using ESG ratings to assess 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. 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.

Please explain what solutions and options you would consider appropriate in order to improve the reliability and comparability of ratings:

As set out in the responses above, solutions include: improving the availability of high-quality and up to date ESG data (the PRI is supportive of global efforts led by the IFRS in this regard and regional developments such as the EU's Corporate Sustainability Directive); and improving the transparency of methodologies so that investors can choose the ESG products that best fit with their investment processes.

Please explain what solutions and options you would consider appropriate in order to clarify what is meant by and captured by ESG ratings, to differentiate from other tools and services:

As set out in the responses above, enhanced transparency of methodologies will also ensure that investors using ESG ratings to assess 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.

[19] 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)

ESG-focused information has historically been tailored to meet the needs of equity investors. PRI research[20] highlighted that fixed income investors utilise ESG information 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.[21] Enhancing transparency of methodologies is an important step towards addressing such issues.

Please explain what solutions and options you would consider appropriate in order to improve transparency on fees charged by the providers:

Clear fee structures can benefit investors, and other users of ESG information products, as it enables them to understand what they're paying for, and it makes it easier for them to compare the prices of different products. Given the recent market consolidation in the ESG information sector and resulting changes[22], the PRI believes that regulators should consider transparency requirements for pricing policies, to facilitate investors and other users' due diligence and decision-making processes on the ESG information products they intend to use.

Please explain what solutions and options you would consider appropriate in order to avoid potential conflicts of interest:

ESG information providers – like other product and service providers in the financial markets – should ensure they have appropriate governance arrangements in place and that offered products and services are free of conflict of interest or other undue influences. This is particularly important for ESG ratings or scores (as well as rankings), where the interplay with other services offered by the same provider could create conflicts of interest (as set out in our earlier response).

To ensure the reliability and quality of the services provided, and proper management of conflicts of interest, specific governance requirements should go beyond a best effort basis and be elevated to mandatory requirements for ESG information products and their providers.

Please explain what solutions and options you would consider appropriate in order to provide some supervision on the operations of these providers:

As set out in the responses above, the PRI believes there should be a legislative intervention to focus on the following issues: transparency of methodologies, and governance and conflicts of interest which would impact on the operations of providers. However, any legislative and supervisory interventions should be proportionate and allow for market innovation when it comes to

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[20] 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)

[21] PRI's ESG in Credit Risk and Ratings Initiative: see https://www.unpri.org/credit-ratings and https://www.unpri.org/credit-risk-and-ratings/do-esg-information-providers-meet-the-needs-of-fixed-income-investors/8067.article?adredir=1

[22] See figure 1 on the PRI's website: Do ESG information providers meet the needs of fixed income investors? | Article | PRI (unpri.org)

methodologies, without interfering with the methodologies themselves. They could also draw on past and existing voluntary standards for responsible investment research, such as ARISTA[23]

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:

As set out in the earlier responses, the PRI believes there should be a legislative intervention to address the key issues of: transparency of methodologies, and governance and conflicts of interest. These should be proportionate and allow for market innovation. To effectively supervise these requirements, an authorisation or registration system may be necessary, however the European Commission will need to determine the nature of the legislative intervention and whether it should be supported in this way.

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:

As per the response above, it is for the European Commission to determine the nature of the legislative intervention, and whether it should lead to an authorisation or registration system for providers offering ESG ratings on EU companies, or non-EU companies' financial instruments listed in the EU.

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:

[23] ARISTA is the Responsible Investment Research Standard, developed in response to the demands from global investors and companies for responsible investment (RI) research groups to incorporate the key principles of quality, integrity, transparency and accountability into their research processes: 2012_Press_release_ARISTA_3_0.pdf (vigeo-eiris.com)

As set out in our earlier responses, the PRI recommends that the European Commission should focus on improving transparency by ESG information providers on their methodologies and processes, by developing minimum quality and transparency standards (including disclosure requirements).

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

- Yes
- **No**
- No opinion

Please explain:

While the PRI is supportive of a legislative intervention (as per our earlier responses), any intervention should be proportionate and allow for market innovation when it comes to methodologies, without interfering with the methodologies themselves or promoting a 'one size fits all' approach. Legislative approaches should focus on clarifying communications (to the extent possible) and processes between market actors to maintain the integrity of ESG information products across all users and ensure they are used appropriately. Legislative approaches may also be required to mitigate issues regarding market barriers to entry and/or conflicts of interest.

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**

Please explain your answer:

N/A. As per the above, while the PRI is supportive of a legislative intervention, any intervention should be proportionate, tailored to the size and nature of the provider, and allow for market innovation.

If you responded yes to the previous question, please specify what metric you consider should be used to differentiate between providers:

- Total revenue
- Revenue from ESG ratings
- Number of employees
- Other metric(s)

- In the case of providers located outside the EU and not providing services to EU investors but rating EU companies/financial instruments – percentage of EU companies/financial products rated

If you responded 'other metric(s)' please explain which one(s):

N/A

Please explain your answer:

N/A

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**

If you responded yes to the previous question, please specify what metric you consider should be used to differentiate between providers:

- Percentage of EU companies/financial products rated
- Other metric(s)
- **Don't know/no opinion/not applicable**

If you responded 'other metric(s)' please explain which one(s):

N/A

PART B – INCORPORATION OF ESG FACTORS IN CREDIT RATINGS

The provision of credit ratings is highly regulated in the EU as well as globally. Global standards are established by the IOSCO in its code of conduct for CRAs. The EU legal framework regulates the activities of CRAs with a view to protect investors and financial markets by guaranteeing the transparency, independence and integrity of the credit rating process – thereby enhancing the quality of ratings. All CRAs operating in the EU need to register with ESMA, which is the sole European supervisor. Credit ratings used for the purposes stemming from the EU legislation need to be provided by CRAs registered and supervised by ESMA. If a non-EU CRA wants its ratings to be used for regulatory requirements in the EU (i.e. by EU financial institutions), the CRA Regulation provides for two alternatives, certification or endorsement.

There are a number of EU regulatory requirements related to the use of credit ratings. , in particular, in the Capital Requirements Regulation (CRR) and in the Solvency Capital Requirement (SCR). The European Central Bank also makes extensive use of credit ratings in its open market operations.

Both EU legislation[24] and the IOSCO code of conduct define precisely the objective of the credit rating: 'credit rating means an opinion regarding the creditworthiness of an entity, a debt or financial obligation, debt security, preferred share or other financial instrument, or of an issuer of such a debt or financial obligation, debt security, preferred share or other financial instrument, issued using an established and defined ranking system of rating categories'.

In other words, credit ratings assess the likelihood of the default of the rated entity or security. Credit ratings reply to the question: "what is the likelihood of getting my money back?" They are neither investment recommendations nor they determine the value of the rated entity or instruments.

ESG risks may be relevant for the assessment of creditworthiness depending on the sector, geographical location and the entity itself. CRAs methodologies define which factors, including ESG factors, are considered to be relevant for the assessment of creditworthiness and how they are taken into account in the credit rating process. ESMA supervises the soundness of methodologies, which in accordance with the CRA Regulation need to be rigorous, systematic, continuous, based on historical experience and back-tested. In its Technical Advice provided to the Commission in 2019, ESMA concluded that while it is clear that CRAs are considering E, S or G factors in their credit ratings, the extent to which each factor is considered varies by asset class, according to the importance assigned to that factor by a CRA's methodology. Currently, ESMA is conducting a thorough assessment of how CRA's methodologies incorporate sustainability risks.

The CRA Regulation includes a number of disclosure obligations in relation to the methodologies as well as individual credit ratings. In 2019, ESMA conducted a public consultation on disclosure requirements applicable to credit ratings. Following the finding on the insufficient transparency on the relevance of ESG factors to credit ratings, one of the topics of the consultation, ESMA issued guidelines on disclosure requirements applicable to credit ratings.

24 Regulation (EU) No 462/2013 of the European Parliament and of the Council of 21 May 2013 amending Regulation (EC) No 1060/2009 on credit rating agencies, https://eur-lex.europa.eu/legalcontent/EN/TXT/?uri=CELEX:32013R0462

These ESMA guidelines expect CRAs to identify in their press releases if ESG factors have been key drivers behind a change in the credit rating. CRAs are asked to identify relevant factors, elaborate on their materiality and provide a reference to the methodology or the associated model. The ESMA guidelines came into effect in April 2020.

A recent assessment of the application of the guidelines revealed that the improvement of transparency has been partial. ESMA has analysed press releases over the period January 2019 – December 2020 and compared the number of references to ESG considerations before and after April 2020. The main findings are that the improvement is partial and not uniform.

This consultation builds on the findings of ESMA and the consultation on renewed sustainable finance strategy.

1. 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 If you use credit ratings for other purposes, please explain :

Comment box *We do not use credit ratings but as PRI we have been working closely with credit rating as part of the [ESG in credit risk and ratings initiative](#).*

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**

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 • [comment box]

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: • [Comment box]

Does the level of disclosure differ depending on individual CRAs?

- **Yes**
- No
- No opinion

If you answered yes to the previous question, please explain the differences in the level of disclosure:

Comment box: *It depends on the size of CRAs an the resources that they have*

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

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

Questions on the need for EU intervention (all respondents)

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 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**

If you responded 'other' to the previous question, please specify the other type of intervention you consider necessary:

Comment Box:

As part of the [ESG in credit risk and ratings initiative](), the PRI has been engaging with fixed income investors and credit rating agencies since 2016 to enhance the systematic and transparent incorporation of ESG factors in credit risk analysis. Overall, the 27 credit rating agencies that are supporting this initiative have made progress in signposting the impact of ESG issues in their analyses and ratings. They have published notes explaining how they incorporate ESG factors into their methodologies, and ESG-related research has grown rapidly. They have built dedicated ESG teams and have expanded resources and analytical tools. And, most importantly, signposting and transparency of how ESG factors contribute to credit rating opinions, when relevant, and how they feature in the assessment methodologies has improved significantly, partly also as a result of ESMA guidelines.

However, progress remains uneven across CRAs, depending on their size and resources. Also, many CRAs have started producing non-credit scores/ratings. Whilst this is in part the result of their effort to make more explicit how ESG factors impact credit rating opinions, the distinction between credit and non-credit ratings has become more blurred, even if the two types of products are developed by different part of the CRA corporate entities. Therefore, more clarity is needed. Finally, the issue of the time horizons and how to assess ESG risks that may affect credit rating opinions beyond the 'typical' credit rating time horizon remains an area that needs attention. Credit rating opinions are based on forecasts and the further out these extend into the future, the more uncertain they become. Nevertheless, although many ESG factors are linked to long-term trends, adjusting to the latter may require changes to business or growth models with credit-quality implications that are near- or medium term (e.g. the costs associated to shift to electric vehicle production in the automotive industry or to plant-based solutions in the food industry). Hence, further detailing of ESMA guidelines on how CRAs should extend the forward-looking component of their credit-opinions would be welcome.

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.

If you responded other, please explain:

Comment box : N/A

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

If you responded 'others', please explain

Comment box : N/A

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**