International Organization of Securities Commissions (IOSCO)
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SPAIN

06 September 2021

CONSULTATION REPORT ON ESG RATINGS AND DATA PRODUCT PROVIDERS

Dear Sir/Madam,

We welcome the opportunity to contribute the following comments following the publication of IOSCO's consultation report on ESG Ratings and Data Product Providers.

The International Regulatory Strategy Group (IRSG) is a practitioner-led body comprising leading UK-based representatives from the financial and professional services industry. It is an advisory body both to the City of London Corporation, and to TheCityUK. The IRSG ESG workstream and the ESG ratings subgroup include representatives from financial services firms, trade associations, the legal profession and data and ratings providers. In responding, we would like to highlight the following from our members:

1. **Right Time for Action**

It is important that market users and investors can have confidence in ESG ratings when making investment decisions. This is likely to become only more important as the influence of ESG ratings, and rating providers, increases. This is the right time to assess the options for improving transparency, and removing issues (particularly around conflicts of interest and external pressures) that may impair the quality of ESG ratings, and to weigh up the relative benefits of regulation versus international guidelines on best practice.

We would caution policy makers not to confuse credit ratings and ESG scorings. Comparison is often drawn with the credit rating markets in an attempt to offer solutions to some of the perceived issues relating to ESG scoring, however such a comparison can be misleading and cause confusion. The ESG scoring market is very different to credit ratings, which have a much higher level of correlation as credit default has a very clear definition which is widely recognised. In contrast, ESG ratings are much broader and measure different realities. While a credit rating is an assessment of the creditworthiness of a borrower, an ESG rating may measure both sustainability-related risks and opportunities. In particular, we think it is not appropriate to consider credit ratings with an E, S, or G component to be captured under the upcoming IOSCO guidelines, as these are not ESG ratings per se but subject to the IOSCO guidelines for credit rating agencies.

We would also caution policy makers not to conflate ESG Ratings and ESG Data Products. Whilst ESG ratings rely on an opinion and utilize methodologies, ESG data products are merely an aggregation, reflection and distribution of reported data and applicable analytics. As such, it is not met with the same or similar issues including potential conflicts of interest and should be reviewed accordingly.

2. **Transparency, consistency and integrity in rating processes are key to market confidence**

In order for rating users and rated entities to have confidence in ESG ratings, to understand the relevant rating factors that underpin ESG ratings, and to carry out appropriate due diligence, it is important to have (i) transparency as to rating methodologies (including sources of data, e.g. public disclosure, estimates, or proxies, and governance process), (ii) confidence as to the consistent application of those rating methodologies by rating providers, and (iii) confidence that ratings are not being influenced by external pressures or conflicts of interest.

We are conducting our own work to assess whether these rules and protections are likely best achieved through market led guidelines/standards or through a move towards proportionate regulation of ESG ratings / rating providers. If the latter, then market regulators could be mandated, for example, to include ESG data providers and ESG rating providers in their scope of regulatory and supervisory responsibilities whereas methodologies and data completeness by ESG rating agencies and ESG data providers could be analysed, audited and validated by competent authorities. Quality of data could also be assessed and qualified. However, regulatory efforts must not interfere with the rating methodologies given the innovative nature of the ESG ratings market that should remain in a position to provide tailored products for the diverse ESG risks companies from different sectors and jurisdictions face. We appreciate, however, that guidelines or voluntary codes of conduct may also be capable of providing a more efficient route towards improving standards internationally.

3. Data gaps

We believe the primary challenge faced by ESG scorings providers is one of data gaps. Data gaps are a manifestation of five interlinked issues:

- Gaps in data availabilities, notably in scope 3 emissions, supply chain and asset-level data.
- Rapidly changing data structure, due to the lack of standardisation of corporate disclosures, labels and taxonomies.
- Ambiguous data ownership within firms: to improve ESG data availability, firms need to enhance the capture of ESG data across domains and as a part of BAU process. This means firms may need to move from a use-case specific approach to ESG data capture, to establishing function- or enterprise-level ESG data management.
- Reliance on un-audited disclosures undermines reliability, comparability, and coverage. This raises the question of ESG data assurance and accreditation more broadly.
- Consumption of ESG data: how ESG data are being used in modelling and decisioning is still being defined – this relates to the need for transparency in ESG scoring/rating, and also financial institutions' use of ESG data more broadly.

For the above reasons, regulatory focus should be on consistent corporate disclosure & reporting as well as on the enhanced management of ESG data. In principle, ESG disclosures by rated companies must be seen in conjunction with the work on ESG ratings, given that ESG disclosures are a critical input factor for ESG rating agencies.

4. Market Users – Increasing understanding and due diligence

There can be no question that financial market participants who use and place reliance on ESG ratings in investment decision-making should be encouraged to conduct detailed due diligence on rating products and the limitations / purposes of rating products. This is only possible if there is a high degree of transparency around rating methodologies, and the consistent application of those methodologies. Given that the growing ESG ratings market is subject to wide ranging business models, any approach should be flexible enough to work across different business models by focussing on the quality of the disclosure, rather than prescribing detailed lists of information to be disclosed. It is not obvious,

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however, that imposing regulatory requirements on market users as regards the due diligence on ratings is necessary or proportionate. This feels more like an area where best practice recommendations or guidelines are more appropriate, and these could (on an individual jurisdictional basis) always be supplemented with rules that apply to specific parts of the market (e.g., to ensure appropriate investment decision making and client information needs for market users holding discretionary mandates for managing client funds in line with agreed investment strategies with an ESG element).

5. **Data Gathering – Improvements are central to rating confidence**

Improvements in the consistency of information, depth of information, and efficiency in provision of information from rated entities to ESG rating providers is desirable. This question cannot, however, be divorced from the wider question of the subscriber pays v. issuer pays model – one benefit that can arise from a (primarily) issuer pays model is that it creates a relationship between the issuer and rating agency whereby a streamlined and confidentiality protected channel for information sharing can be created. This is also achievable in a subscriber pays where advanced communication of requests for information, use of accurate pre-inputted information, clear and consistent contact points, principal grounds of assessment pre-publication and the entities' ability to draw attention to any factual errors are essential to rating quality. But, absent these, pressures on market depth and coverage could lead to a greater number of unsolicited ratings without full transparency as to the nature and depth of information received from the rated entity on which the rating is based. We suggest that work in this space should be progressed having regard to the interplay between these two aspects.

The manner in which this transparency is made should be relevant to the data to which the transparency pertains. For example, disclosures could be written in methodology documents shared with clients or during due diligence meetings, or client due diligence questionnaires, which users of the data may choose to employ. However, there may be instances where complete transparency is not reasonably possible such as the protection of intellectual property rights.

In addition, the type of transparency can differ depending on the type of data product being provided. For example, source transparency would be the most applicable for data collected from public sources whereas calculation methodology is more applicable to data which is calculated and created following an automated approach. We note that this recommendation is more relevant to ratings rather than data products where we encourage that a clear distinction be made.

Concluding comments

We stand ready and willing to continue to engage with IOSCO on this important project and look forward to opportunities to exchange more detail in the future. The IRSG is in the process of producing a report together with Accenture on ESG ratings which will cover the market landscape and key players; consistency in ESG data and ratings; the role and usage of data in ESG ratings as well as the transparency of the methodologies and any current supervision of ESG ratings. We look forward to sharing the report and the IRSG's policy recommendations with you later this year.

We thank you for considering this submission.
For any questions or clarifications please contact: *IRSGsecretariat@cityoflondon.gov.uk*