ESG ratings and ESG factors in credit ratings – consultation response

To	European Commission
From	DUFAS (the Dutch Fund and Asset Management Association)
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Subject	DUFAS response to the EC consultation on the functioning of the ESG ratings market in the European Union and on the consideration of ESG factors in credit ratings
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DUFAS (the Dutch Fund and Asset Management Association) welcomes the opportunity to respond to the public consultation on the functioning of the ESG ratings market in the European Union and on the consideration of ESG factors in credit ratings, as published by the European Commission on 4 April 2022.

Executive Summary

There is an increasing demand from asset managers for ESG ratings and data products due to the growing sustainable investment activities of asset managers and the requirements for complying with European regulatory frameworks on sustainable finance.

We also stress that the demand for ESG ratings should not be confused with the need for ESG data or other data products. In this regard, we encourage global definitions setting as to ESG ratings on one hand and ESG data on the other hand, such as the IOSCO's definitions. The use globally aligned definitions for consistency and recognise the global nature of many of these providers.

DUFAS and its members emphasize the need for a well-functioning ESG ratings market that provides relevant, reliable, and comparable ESG ratings. However, DUFAS would like to address some key considerations that should be well-thought-out if a (legislative) framework would be considered.

Key-considerations

Access to a variety of service providers
The main concern is that a mandatory European regulatory framework will result in fewer ESG ratings providers entering the European market because of an increase of complexity and fees. At this moment, asset managers are concerned about gaps and holes that exist in the available ESG ratings and data products in order to be able to comply with national legislation. It is important that data is made available for asset managers to comply with new EU legislation such as EU Taxonomy and SFDR. We believe that a regulatory framework could potentially lead to less variation in tools and services available for European asset managers.

Increase in costs and complexity
DUFAS and its members would like to stress the concern that compliance with a legislative regime brings compliance costs which could result in higher costs for ESG ratings for asset managers. It is important that compliance costs remain low in order to make sure that ESG ratings are affordable and available for a competitive market price for European asset managers, in particular for mid to small managers. A European regime does not automatically result in a global standard. SSPs and asset managers operate in a global market. When the regulatory regime is solely covering the European market, it is not guaranteed that other

regions will follow European requirements for ESG ratings provided by ESG ratings providers. Therefore, there could still be differences in the quality provided to non-European and European clients. This impedes the development of a global level playing field.

Comparability of ESG ratings remains an issue
DUFAS members experience that ESG ratings providers tend to use different methodologies for assessing the ESG ratings of corporate issuers, and the same may apply to the future integration of ESG or taxonomy principles in their research. We believe that is a concern where no transparency is being given on the methodologies and the data sources used. ESG ratings from various data providers should be comparable. As to the ratings themselves, one could argue that ratings can differ between ESG rating providers even if the source ESG data would be the same as the ratings are an opinion based on the ESG data. However, it may not always be clear whether ESG ratings are based on data or approximations.

The conclusion is therefore that the comparability of ESG ratings remains an issue when there is insufficient transparency of the methodologies and the data sources used, and ongoing obligations to communicate changes hereof in a timely manner. Without this, it is still difficult to make clear company comparisons and it remains challenging to enable portfolio and investment choices based on the ratings and data products available. Therefore, in the event ESG ratings providers will be regulated, transparency on the methodologies, clarity on the purpose of the ratings such as performance work-based or outcome-based also in the name of ratings, and the use of underlying data sources is key as to enable market parties to compare such ratings and to value and assess the outcome thereof.

Other options available: Due diligence and contractual agreements
At this moment, asset managers conduct due diligence in their selection of data providers. This is a time consuming and costly process. Instead of a mandatory regulatory regime, it could also be considered to provide more guidance in the due diligence process and contractual agreements that asset managers can use, and which could be applied to the global data providers' market. As such, mandatory transparency on the methodologies and the use of underlying data by ESG ratings providers could and should be included in contractual arrangements. In addition, it is expected that ESAP will lead to better comparability of ESG data, increased transparency and lower barriers and costs. This could raise the question if a regulatory framework in addition to ESAP would be needed.

Furthermore, we encourage providers to develop best practice codes on identifying, managing, and disclosing conflicts of interest, especially when an ESG ratings provider performs consulting services for companies subject to its ESG ratings and products services or when a company pays the provider for being rated instead of the consumer