association of the luxembourg fund industry

Luxembourg, 11 March 2022

Position paper on ESMA's call for evidence on market characteristics for ESG rating providers in the EU

Introduction

The Association of the Luxembourg Fund Industry (ALFI) represents the face and voice of the Luxembourg asset management and investment fund community. The Association is committed to the development of the Luxembourg fund industry by striving to create new business opportunities, and through the exchange of information and knowledge.

Created in 1988, the Association today represents over 1,500 Luxembourg domiciled investment funds, asset management companies and a wide range of business that serve the sector. These include depositary banks, fund administrators, transfer agents, distributors, legal firms, consultants, tax advisory firms, auditors and accountants, specialised IT and communication companies. Luxembourg is the largest fund domicile in Europe and a worldwide leader in cross-border distribution of funds. Luxembourg domiciled investment funds are distributed in more than 70 countries around the world.

We thank the European Securities and Markets Authority for the opportunity to participate in this call for evidence on market characteristics for ESG rating providers in the EU.

Response to selected parts of the Questionnaire

6.2.4 General views on ESG ratings in EU Financial Markets

Q1. Please provide your views on the level of relevance of ESG ratings to EU financial markets and financial market participants. Do you consider this level will increase in the coming years.

First of all, we shall distinguish between ESG ratings, ESG indicators (such as the indicators defined under SFDR (PAI) or Taxonomy alignment) and underlying ESG raw data (i.e. the ESG data points used in order to calculate ESG ratings and ESG indicators).

<u>ESG data</u>

With the increasing number of mandatory ESG indicators imposed by SFDR/Taxonomy Regulation, as well as managers increasingly opting for proprietary ESG analysis tools (see our comments to question 2 in this regards), the availability/coverage, the up-to-dateness and reliability of ESG data and ESG indicators are of increasing relevance and key concerns to the industry.

ALFI is indeed of the view that key concerns are the availability and reliability of ESG data points to calculate these indicators required by SFDR/Taxonomy (PAI, TSC, DNSH...) and comply with asset managers' own regulatory requirements. Asset managers are really struggling in getting these ESG data that are not, for many of them, available or incomplete or unreliable. Another key concern in this

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context is the transparency of calculated ESG data points (methodology, proxies, data sources) provided by 3rd party data providers.

These issues are exacerbated by the information sequencing gap, where issuing companies will start providing relevant non-financial information several years after asset managers are called to make disclosures in absence of information coming directly from companies. As a result, the regulations have inadvertently created inelastic demand for ESG data. Then, CSRD will only cover a certain scope of companies either based in the EU or related to the EU market, but not all portfolio companies. For data not covered under CSRD, asset managers will continue to rely on third party providers and their assessments.

Focus shall really be in ensuring that investee companies shall be reporting these ESG data points and that these data be available in a centralised, structured and digital way (API) through the ESAP project or alike initiatives, while focusing scrutiny on the reliable data delivery by reporting entities irrespective of the finally chosen centralizing data venue. The appropriate quality checks should be embedded in the databases (or the supporting documentation/elements to perform data quality checks) so that all relevant stakeholders can validly rely on data made available by investee companies. We shall nevertheless acknowledge that CSRD will only cover a certain scope of companies either based in the EU or related to the EU market, but not all portfolio companies. For data not covered under CSRD asset managers will continue to rely on third party providers and their assessments.

ESG Indicators (SFDR/Taxonomy)

Financial market participants/ asset managers use multiple sources of information and data vendors for their needs under SFDR and the Taxonomy Regulation, as well as information they need to provide to the end investors either directly or via distributors and intermediaries. Some of our members have identified very significant divergences in the PAI indicators, Taxonomy eligibility and Taxonomy alignment percentage reported by different ESG data providers. ESG data providers are indeed compensating the lack of ESG data reported by underlying companies by using estimates (based on peers or sectoral data) or, in the absence of data points required by the regulators, some data vendors are using proxy methodology. We are deeply concerned by the delay in getting comprehensive, reliable and transparent ESG data supporting robust and transparent ESG indicators calculation and the resulting reporting risks in the intermediate period.

Q2. Please provide your views on the level of risk ESG ratings currently pose to orderly markets, financial stability and investor protection in the EU. Do you consider this level will increase in the coming years.

ESG concept is not globally defined (the EU could take the lead on the definition). As a result, there is a lack of correlation between core ESG agencies for the same assets: a fund or a company rating can differ greatly between agencies as agencies would be using their own definitions, methodologies and standards to define their score/rating scale.

Nonetheless, it can prove challenging to strike the right balance between serving correlation and not enabling a too generic approach.

It should not be disregarded that sustainability factors and their relevance or materiality for the respective stakeholder can differ and can be multi-faceted. These factors cannot in a one-size-fits-all approach be distilled into one single metric. Such an approach could bear a systemic risk of large simultaneous outflows in case of bad ratings.

We understand in this context that some asset managers/funds have opted for proprietary tools to allow them to perform their own analysis based on their individual assessment of relevant aspects. Accordingly, we believe that while seeking correlation, a certain level of differentiation and flexibility should also be maintained when regulating providers of ESG rating and ESG indicator calculations.

Furthermore, the processes used by rating agencies should be transparent, in particular for retail investors. Retail investors may pay especially close attention to ESG ratings and base their investment decisions on them. It should be transparent to investors what ESG ratings and their measures entail, how they are being carried out, based on which data and as how reliable the data used can be considered.

It could be considered to be beneficial to require both, rating providers and users of ratings (such as asset managers) to disclose, in short, the methodology for their rating approach (as required under SFDR draft RTS for Financial Market Participants) and its limitations as well as the methodology for their normalisation approach to rating scales to highlight possible bias in the ratings.

A code of good practice for ESG rating providers may be considered to be implemented, as a soft law tool or guidance which could foster transparency within this activity.

In general, we stress out that the right tools should be in place without jeopardizing the diversity of choice for investors.

A further issue that may be addressed in this context is that sudden changes of governance practices by rating agencies may not always allow for proper/timely reaction and correction of errors/misalignments identified.

Despite the challenges identified, we recognize that the risk of misrepresentation regarding the extent and importance of ESG ratings and related indicators in investment processes may lessen over time as disclosure standards in Europe improve.

While ESG ratings may inform trading decisions, the diversity of ESG ratings and related indicators in use for this purpose allows for selection, which somewhat protects against herd behaviour and related market discontinuities.

Nonetheless, as mentioned above, we remain concerned about the time it will take to fully develop the taxonomy across EU sectors and address social objectives. Quality, completeness, accessibility and reliability of the non-financial data reported by corporates impact also negatively the ESG data available.

A further major issue that goes beyond the question on ESG ratings is a lack of and discrepancies between the transparency shown by data vendors regarding how they developed their findings on taxonomy alignment based on certain raw data (see our comments answering the question1).

Rating agencies very often compensate for the lack of ESG data points disclosed by issuers by using estimates based on peer or sectoral data to rate companies. Such approaches may amount to increased greenwashing risk and could lead some issuers to adopt strategies of publishing (or withholding) information in a way that is to their advantage.

This is a vicious circle because rating agencies are faced with potential clients from the financial world - under pressure to provide various reports - for whom the coverage rate is a determining factor in the choice of a provider, which encourages them to use estimates.

The rather inelastic demand for ESG data created by regulation also gives pricing power to ESG data providers. Consequently, another area that we would suggest regulators to currently pay attention to is the concentration and price competition in the market.

However, as financial markets thrive on information, the availability of new and cleaner data from

issuers may facilitate price discovery over time. It could possibly eventually also help to mitigate systemic market risk.

Finally, the risk of conflict of interest between ESG scoring agencies and their parents is another issue that may deserve attention.