Environmental, Social and Governance (ESG) Ratings and Data Products Providers. International Bulletin, March 2022.

In November 2021 the International Organisation of Securities Commissions (IOSCO) published a report called "Environmental, Social and Governance (ESG) Ratings and Data Products Providers" which reflects, among other significant issues, the exponential growth in the use of ESG ratings and data products as a result of investors' growing interest in companies that develop sustainable activities.
This industry segment status report conducts a data collection exercise on ESG ratings and data product providers, their users, and the companies subject to these assessments. More than 65 capital markets participants were involved in the exercise through surveys.

The report is structured in five chapters: i) An overview of the market for ESG ratings and data products; ii) Existing practices; iii) Issues surrounding users of ESG ratings and data products; iv) Connections between companies subject to ratings and providers of ESG ratings and data products; v) Establishment of recommendations for securities regulators, providers of ESG ratings and data products, users and companies subject to these assessments.

I) General overview of the ESG ratings and data products market
The IOSCO report highlights the lack of harmonisation on the definitions of ESG and ESG data products as well as the lack of transparency on the methodologies used and the potential conflicts of interest between providers of ESG ratings and data products and the companies subject to these evaluations.

The absence of a consolidated supervisory activity on these matters, together with the potential growth of product and service providers, generates caution regarding the adequate protection of investors, the efficient functioning of the markets, the assessment of existing risks and the efficient allocation of existing capital resources.

The lack of consistent, harmonised and comparable information in relation to companies' ESG reporting obligations makes the homogenisation of the content of ESG ratings and data products decisive in making investment decisions, especially for asset management companies and other institutional investors.

This IOSCO report highlights the desirability of implementing an annual sustainability report by the issuing companies in which the ESG information progressively resembles the annual financial report, both in its content and in its structure and periodicity. Another factor identified refers to the need to increase cooperation and dialogue between the various providers of ESG ratings and data products in order to mitigate inconsistencies and possible asymmetries. The current disparities make this advisable.

II) Providers of ESG ratings and data products

This chapter describes the practices and experiences of providers of ESG ratings and data products, their sources of information, the methods used, the main challenges and the existing business models. A first conclusion is based on the fact that the certainty and quality of the data analysed determines the quality of the content of the ESG ratings and data products.

The range of data used among the different providers of these products and services is very heterogeneous, from information on corporate governance and financial strategies to information on the physical or transition risks of climate change. The consequence is that the comparability and harmonisation of the reports lack a common denominator, to the detriment of an advisable uniformity of the assessments made.

ESG data are disseminated through various channels, such as annual reports, sustainability reports and websites. The effect is the inconsistency in the format, content and location of the information disclosure to the detriment of

its comparability. The IOSCO report points out the urgency and need to increase the consistency, comparability and reliability of existing sustainability reports.

II a) Remuneration model

The sources used by the companies that provide ESG ratings and data products adopt different modalities, such as corporate public information and questionnaires completed by the companies analysed.

The different purpose of the existing ratings, the different weight of the quantitative or qualitative element of the existing information, the different verification processes of the base information of the ratings and of the data products, as well as the different treatment of the financial materiality, increase the heterogeneity among existing methodologies.

The remuneration payment model for providers of ESG ratings and data products adopts different modalities. Depending on the existing remuneration model, conflicts of interest differ.

The "Subscriber Pays" model is dominant in the ESG data product provider industry, accounting for 85% of the existing business model. This model puts pressure on information providers by prioritising quantity over quality of information. With this model, retail investors are at a disadvantage, since the costs of subscribing to different products are often unaffordable.

The "Issuer Pays" model predominates in ESG ratings, as a result of both factors introduced in the new regulation and the evolution of existing market practices. The report highlights that there is a high interrelation between the existence of an ESG rating or data products and a financial benefit of the entity analysed. In this case, the incentives for the issuer-entity analysed are greater and the "Issuer Pays" model becomes more significant.

III) Public and private users of ESG ratings and data products

This chapter analyses the use of ESG ratings and data products data both by the private sector (asset management companies, investment funds and corporate entities) and by the public sector (public pension funds, central banks and public financial institutions).

The IOSCO report identifies that asset management companies integrate ESG factors into investment or divestment processes, both to identify investment opportunities for their portfolios and to monitor products rated as sustainable.

The standardisation and increase of corporate information, as well as its reliability, is a need demanded by users and consumers of ESG ratings and data products. The IOSCO report reveals a certain distrust of users towards reports on ESG prepared by providers external to the organisation of the companies analysed, which has made it possible to develop internal systems specialised in ESG.

The internal ESG systems show greater resilience in their adaptation to the sector and the particularities of each company and portfolio. However, the costs of implementing internal methodologies in small and medium-sized companies are excessively high, to the detriment of competition.

IV) Final recommendations

The report incorporates a set of Recommendations divided into five sections.

A) Recommendations for authorities regarding ESG ratings and data products.

Recommendation 1) ***Regulators could consider focusing more attention*** *on the use of ESG ratings and data products and ESG ratings and data products providers that may be subject to their jurisdiction.*

The Recommendation reflects the need for adequate regulation. The regulation must be proportionate, without prejudice to common elements to favour the comparability and homogeneity of these activities.

B) Recommendations for providers of ESG ratings and data products.

Recommendation 2) *ESG ratings and data products providers could consider adopting and implementing* ***written procedures*** *designed to help ensure the issuance of high quality ESG ratings and data products based on publicly disclosed data sources where possible and other information sources where necessary, using transparent and defined methodologies.*

Recommendation 3) *ESG ratings and data products providers could consider adopting and implementing* ***written policies and procedures*** *designed to help ensure their decisions are independent, free from political or economic interference, and appropriately address potential conflicts of interest that may arise within their organisations.*

Recommendation 4) *ESG ratings and data products providers could consider identifying, avoiding or appropriately managing, mitigating and disclosing potential* ***conflicts of interest*** *that may compromise the independence and objectivity of the ESG ratings and ESG data products provider's operations.*

Recommendation 5) *ESG ratings and data products providers could consider making adequate levels of* ***public disclosure and transparency*** *a priority for their ESG ratings and data products, including their* ***methodologies*** *and processes to enable the users of the product to understand what the product is and how it is produced, including any potential conflicts of interest and while maintaining a balance with respect to proprietary or confidential information, data and methodologies.*

Recommendation 6) *ESG ratings and data products providers could consider adopting and implementing written policies and procedures designed* ***to address and protect all non-public information received from or communicated*** *to them by any entity, or its agents, related to their ESG ratings and data products, in a manner appropriate in the circumstances.*

These Recommendations aim to introduce transparency in these activities with written procedures that avoid opacity, allow a better understanding of their content and facilitate proper management of possible existing conflicts of interest.

C) Recommendations for market participants, users of ESG ratings and data products.

Recommendation 7) *Market participants could consider* ***conducting due diligence*** *or gathering and reviewing information on the ESG ratings and data products that they use in their internal processes. This due diligence or information gathering and review could include an understanding of what is being rated or assessed by the product, how it is being rated or assessed and, limitations and the purposes for which the product is being used.*

This Recommendation suggests the possibility of carrying out a due diligence procedure on the content of these products and services, as it constitutes a determining element in the adoption of decisions by investors. Aspects such as the quality of the data, their updating, methodologies and human capital determine the quality of these activities.

D) Recommendations on the possible interrelationships between the providers of ESG ratings and data products and the entities evaluated.

Recommendation 8) *ESG ratings and data products providers could consider improving* ***information gathering processes*** *with entities covered by their products in a manner that leads to more efficient information procurement for both the providers and these entities.*

Recommendation 9) *Where feasible and appropriate, ESG ratings and data products providers* ***could consider responding to and addressing issues flagged by entities covered by their ESG ratings and data products****, while maintaining the objectivity of these products.*

These Recommendations intend to promote the interrelation and cooperation between the evaluators and those evaluated, to favour their efficiency without detriment to the objectivity of the evaluations.

E) Recommendations on how the evaluated entities could assess the possibility of interacting with their providers of ESG ratings and data products.

Recommendation 10) *Entities subject to assessment by ESG ratings and data products providers could consider* ***streamlining their disclosure processes for sustainability related information to the extent possible****, bearing in mind jurisdictions' applicable regulatory and other legal requirements.*

This Recommendation can materialise through specific links on corporate websites or in corporate information, with periods for updating the information and with contact points to resolve specific questions on this matter.

Useful link:

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