



Deadline: 6 June 2022

FIA EPTA response to the European Commission consultation on the functioning of the ESG ratings market in the European Union and on the consideration of ESG factors in credit ratings

Introduction:

The FIA European Principal Traders Association (FIA EPTA) welcomes the opportunity to respond to the European Commission consultation on the functioning of the ESG ratings market in the European Union and on the consideration of ESG factors in credit ratings

FIA EPTA represents 24 independent European Principal Trading Firms (PTFs) which deal on own account, using their own money for their own risk, to provide liquidity and immediate risk transfer in exchange-traded and centrally-cleared markets for a wide range of financial instruments, including shares, options, futures, bonds and ETFs. FIA EPTA's members are based in the Czech Republic, Germany, Ireland, The Netherlands, and the UK.

Our members are independent market makers and providers of liquidity and risk transfer on trading venues and to end-investors across Europe. Market making and liquidity provision (also referred to as principal trading or dealing on own account) is a distinct activity that is undertaken by non-systemic investment firms rather than banks, in a highly dispersed and varied ecosystem of independent Principal Trading Firms. These firms operate in an innovative and competitive fashion leading to a vibrant, dynamic and diverse ecosystem which massively reduces interconnectedness and increases substitutability. This fundamentally reduces systemic risk whilst improving market quality and lowering costs for retail and institutional investors alike.

In 2019 FIA EPTA established a Sustainable Finance Committee for its member firms to explore how liquidity providers can contribute to the green transition. It is FIA EPTA's view that sustainable finance offers a great promise in unlocking investment capital that is essential for fighting climate change and mitigating its impact for citizens. To be widely accepted by investors, sustainable finance products need to be embedded in a healthy secondary market environment which ensures liquidity and enables investors to risk-manage their exposures.

FIA EPTA is committed to supporting policymakers and regulators in ensuring the success of the sustainable finance project at all levels of the capital market ecosystem. We would welcome the opportunity to provide further background to the European Commission on the issues raised in our response.

Part A – ESG Ratings Use of ESG ratings and dynamics of the market

Questions for all respondents:

Q: Do you consider that the market of ESG ratings will continue to grow?

Yes

Q: 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 to 10?

	1	2	3	4	5	6	7	8	9	10	Does not apply
Growth in demand from investors in ratings of companies for their investment decisions										X	
Growth in demand from companies in ratings including on rating future strategies									X		
Further standardisation of information disclosed by companies and other market participants							X				
Other									X		

Q: Please specify what other reason(s) you see for this market to continue to grow:

“Growth in regulation on ESG ratings”. FIA EPTA members believe regulation is needed to build credible and meaningful ESG ratings. Investors need the ESG ratings for their investment decisions, as ESG investments are growing, the demand for ESG ratings will only grow. FIA EPTA members believe that through regulation, more transparency and harmonisation can be released which is needed to make meaningful investment decisions and for the trust in the data.

Q: Are you considering to use more ESG ratings in the future?

not applicable

Q: Do you mostly use ESG ratings from bigger or larger market players?

not applicable

Q: Do you consider there is a sufficient offer of ESG ratings from providers located in the European Union?

Yes

Q: If you responded ‘yes’ to the previous question, please explain why:

FIA EPTA members believe there are sufficient providers of ESG ratings in the European Union, however, FIA EPTA members believe that the meaningfulness of the ESG ratings needs to be improved. Through standardisation and harmonisation of ratings, this can be achieved. The credibility of the ESG ratings should be improved, so that way the trust of investors in the data will grow.

Q: Finally, do you use other types of ESG assessment tools than ESG ratings (e. g. controversy screening, rankings, qualitative assessments, etc.)?

not applicable

Q: 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?

FIA EPTA members believe that, for now, ESG research products have not yet reached a sufficient level of maturity and comparability to allow users to fully understand the products that they use. FIA EPTA members believe ESG ratings are extremely relevant for EU financial markets and financial market participants. Most financial market participants base their investment decisions based on internal reviews in combination with available data from data/rating providers. The data from these companies need to be transparent and clear about what they entail.

FIA EPTA members believe that the transparency of the methodology and objectives of the ESG ratings is important and needs to be straightforward. Rating agencies should work together with trading platforms and index providers to create a system in which it is easy to understand which ESG parameters the data is based on. As ESG is an ever-growing concept of which more and more characteristics are part. FIA EPTA members believe that it should be clear on which ESG characteristics an ESG rating is based, for example in the case of an index, is it based on 'best in class', which means that certain companies could be part of the index that have or contribute to high carbon emissions.

In addition, FIA EPTA members observe a large variety of ESG rating providers in the market, due to the absence of standardization of ESG indicators. This is mainly because of measurement divergence, meaning that agencies measure the same attribute using different indicators. Next to measurement divergence, weight, scope and aggregation of indicators play a role in the lack of correlation between the different ESG ratings. This makes it difficult, if not impossible, to come up with truly meaningful and harmonised ESG ratings between the different rating agencies. FIA EPTA members would like to encourage establishing more standardisation so that the comparability of these ratings increases.

II. Functioning of the ESG ratings market

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

Not well

Q: Please explain your answer:

FIA EPTA members believe that ESG data and ratings are relevant and needed for financial market participants, institutional investors and (professional and personal) end-investors who use ESG ratings

and data to make investment decisions. ESG investments will grow and for the trust of financial market participants in these products, more transparency is needed.

FIA EPTA members also believe that ESG ratings should also focus more on climate opportunities and not just on low carbon portfolios as will be needed for the transition towards a sustainable financial ecosystem. Climate opportunities will play a much more important role as it embodies the change that is needed toward sustainable capital markets and to realise climate goals as low carbon portfolios are focused too much on companies that do not or contribute less to the transition.

The large variety of ESG ratings makes it unclear which characteristics were used and how much the characteristics weigh in the overall rating. FIA EPTA members believe that harmonisation is needed and those rating providers should make a clear and transparent judgement on products. For example, it should be clear for listed companies to what extent their ESG rating is based on their carbon emissions and/or if their social and governance goals are based on global or regional targets, this also includes if their supply chain is included in the ESG rating. Trading platforms and index providers should clearly state which characteristics have been taken into account so that financial market participants can make a conscious investment decision. Some index products compare listed companies irrespective of the industry and/or based on exclusion while others indexes create best-in-class benchmarking thereby allowing representation of all industries which is an important difference.

Q: 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	2	3	4	5	6	7	8	9	10	Not applicable
Lack of transparency on the operations of the providers									X		
Lack of transparency on the methodologies used by the providers									X		
Lack of clear explanation of what individual ESG ratings measure									X		
Lack of common definition of ESG ratings										X	
Variety of terminologies used for the same products								X			
Lack of comparability between the products offered									X		
Lack of reliability of the ratings											X
Potential conflicts of interests											X
Lack of supervision and enforcement over the functioning of this market								X			
Other <u>Usability/meaningfulness</u>										X	

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

Usability/meaningfulness

FIA EPTA members believe that the ESG rating providers have the best intentions with their data. However, FIA EPTA members believe that the usability and meaningfulness of the data, especially on the comparability of different rating providers need to be improved. That transparency will benefit the trust of investors in ESG data.

Q: What do you think of the quality of the ratings offered, on a scale from 1 to 10 ?

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Q: Please explain why:

FIA EPTA members believe the quality of individual rating providers is adequate but we observe a large variety of different ESG ratings in the market due to many different providers that use different indicators which creates less transparent rating products. FIA EPTA members believe that more harmonisation and standardisation are needed for the ESG ratings that are being offered. This in combination with regulation for ESG rating providers will improve the quality and trust in ESG products. FIA EPTA members view this as creating truly meaningful and credible ESG data products that benefit the market and can be compared with other data providers.

Q: If you responded ‘very poor’ or ‘poor’ to the previous question, to what degree do you consider that this affect your trust in the products that are offered, on a scale from 1 to 10?

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Q: Please explain why:

FIA EPTA members believe that ESG ratings are a very important component of how investors make their investment decisions. There needs to be trust in the underlying data, especially with ESG data. If a green bubble is created with faulty data will that harm the green transition enormously. That is why more transparency and standardisation are needed to prove why some products are deemed ESG and some are excluded.

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

No

Q: Please explain your answer to question 1:

FIA EPTA members believe much more transparency of methodology and objectives is needed before the correlation between products will be improved. FIA EPTA members observe a large variety between ESG rating providers in the market, due to the absence of standardisation of ESG indicators. This is mainly because of measurement divergence, meaning that agencies measure the same attribute using different indicators.

Q: How much do you consider each of the following to be an issue, on a scale

	1	2	3	4	5	6	7	8	9	10	Not applicable
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There is a lack of transparency on the methodology and objectives of the respective ratings									X		
The providers do not communicate and disclose the relevant underlying information											X
The providers use very different methodologies									X		
ESG ratings have different objectives (they assess different sustainability aspects)									X		
Other issue(s)											X

Q: 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 negative

Q: Please explain your answer:

FIA EPTA members acknowledge that there exist a different variety of (traditional) rating agencies and products that use different methodologies and objectives. That having said, FIA EPTA members believe that in particular with ESG rating providers/products there is too much variety that makes it less transparent to compare and come to a conclusion on a product.

Q: To what degree do you consider this market to be prone to potential conflicts of interests on a scale from 1 to 10?

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Q: Please explain your answer:

FIA EPTA members believe that due to the unregulated structure of the ESG data rating providers it could be prone to potential conflicts of interests. FIA EPTA members believe that ESG data rating providers should be regulated in the same way as other (non-ESG) rating providers.

PART B - Incorporation of ESG factors in credit ratings

III. Questions on the need for EU intervention

Q: Do you consider that the current trends in the market are sufficient to ensure that CRAs incorporate relevant ESG factors in credit ratings?

No

Q: 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?

No

Q: If you responded 'no' to the previous questions, what type of intervention would you consider necessary?

- Further supervisory actions by ESMA
- Legislative intervention

Q: Regarding the possible regulatory intervention, what type of requirements do you find relevant?

- Methodologies: require CRAs to explain the relevance of ESG factors in methodologies
- Methodologies: require CRAs to take into account ESG factors where relevant

Q: 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

Q: What would be the consequences of the lack of the EU intervention?

- 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

III. Questions on the need for EU intervention (all respondents)

Q: Do you consider that the current trends in the market are sufficient to ensure that CRAs incorporate relevant ESG factors in credit ratings?

No

Q: 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?

No

Q: If you responded 'no' to the previous questions, what type of intervention would you consider necessary?

Legislative intervention

Q: Regarding the possible regulatory intervention, what type of requirements do you find relevant?

- 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

Q: 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

Q: What would be the consequences of the lack of the EU intervention?

- 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