



Just in Time

Environmental, Social and Governance
(ESG) Ratings and Data Products
Providers
IOSCO

Dec 2021

 **iason** ESSENTIAL SERVICES FOR
FINANCIAL INSTITUTIONS

Environmental, Social and Governance (ESG) Ratings and Data Products Providers IOSCO

Dec 2021

Executive Summary

Usage and role of **ESG rating and data products** has grown significantly: **investors increasing interest** in companies that take account of *sustainability* led to a **surge in demand** for ESG rating and data products by financial market participants, with a consequent **proliferation of participants** in this industry.

The development of ESG rating and data products highlighted the **lack of a regulation** of the market.

A fact-finding exercise conducted by **IOSCO** (International Organization Of Securities Commissions) with providers, users and companies which are the subject of these ESG ratings and data product, revealed the following gaps:

- little clarity and alignment on **definitions** of what ratings or data products intend to measure;
- lack of **transparency** about methodologies used;
- uneven **coverage** of product offered on industries or geographical areas;
- concerns about the management of **conflict of interests** regarding consulting services offered;
- need of better **communication** to ensure reliable information on ESG rating or other data products.



At a Glance



01	<u>Product and Market Overview</u>	4
02	<u>ESG Ratings and Data Products Providers</u>	7
03	<u>Private and Public Users of ESG Ratings and Data Products</u>	11
04	<u>Companies and ESG Ratings and Data Products Providers</u>	14
05	<u>Final Recommendations</u>	17

01

Product and Market Overview

Product and Market Overview

Coverage of ESG Ratings and Data Products and Public Disclosure



Product and Market Overview 1/2

ESG rating and data products market is rapidly growing, thanks to two main drivers:

- increasing legislative and regulatory focus on the considerations of ESG investments characteristics;
- increasing demand from investors for sustainable products.

Providers and Consolidation

It has been estimated to be **160 providers worldwide**, which offer large or specialized ESG-related products.

Since global market is preferring a small number of providers with a global presence, some of these larger market participants are acquiring ESG providers with a more regional focus and more specialized services offering.

ESG Rating Products

“**ESG ratings**”, including ESG scoring and ESG ranking, measure the exposure to ESG risks and/or opportunities and results from both quantitative and qualitative analysis, therefore they may incorporate an element of analytical judgement or opinion.

ESG ratings are usually not defined in absolute terms but are generally assessments relative to a peer group.

Variety of Products Provided and Offering growth

ESG ratings and data product offerings are evolving in response to investor needs, based on new topics of interest and emerging areas of attention.

Product names, objectives and methodological practices can vary significantly across providers, due to lack of global standards.

ESG Data Products

- **Raw data** gathered by data products providers or collected through questionnaires;
- **Screening tools** assess the exposure to ESG risks to define a portfolio based on ESG criteria
- **Controversies alerts** enable investors to monitor practices that could lead to reputational risks and affect the company and its stakeholders.

Product and Market Overview 2/2

Coverage of ESG Ratings and Data Products and Public Disclosure

ESG Rating Products

- While some providers do cover private companies, there is a heavier weighting of ratings coverage for **publicly listed companies**.
- Geographically**, coverage is weighted towards the providers "home" financial markets, but also jurisdictions with sophisticated and developed financial markets weight.

ESG Data Products

Coverage of ESG data products replicates the findings for ESG rating products. Additionally, there can be **regional variations** for ESG data products most commonly used.

Degree of variance between the **most popular data product offerings** from different providers, depending on different segments of the market, regions or needs.

Geographic Preferences Variations

The popularity of ESG ratings and data products can vary by **geographic region** and within **individual jurisdictions**.

These preferences can be seen as a combination of **investor demand** and **regulatory requirements**.

Smaller VS Larger Institutions

Outside of Europe and the US, demand for ESG data products depends on the **size of the client**:

- smaller** institutions are more likely to subscribe to platforms with scoring information;
- larger** clients usually subscribe to databases of raw ESG data.

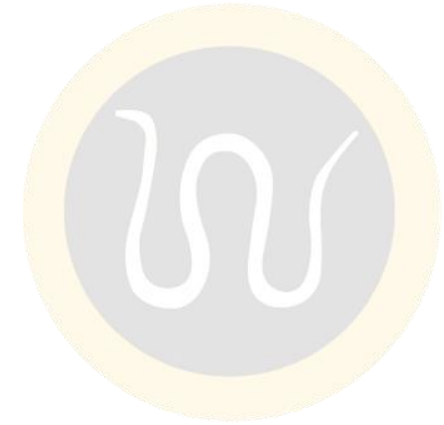
Public Disclosure of ESG Ratings and Data Products

Public disclosure of **fund level** aggregate ESG ratings appears **more systematic** than for company ratings, while **non-profit** companies tend to make their **ratings public**.

02

ESG Ratings and Data Products Providers

Reliability and Availability of Inputs – Raw ESG Data
Methods Used in the Industry



ESG Ratings and Data Product Providers 1/3

Reliability and Availability of Inputs – Raw ESG Data



Difficulties with Entities Disclosure Practices

The lack of standardization of ESG-related disclosure requirements brings difficulties in sourcing reliable data inputs.

Critical points are:

1. **Availability:** the low volumes of ESG information in certain regions can negatively affect quality and coverage of ESG ratings and data products.
2. **Inconsistency:** different format, content and location of disclosed ESG data brings the risk that not all relevant information will be gathered by all providers. Since implementation of disclosures required is at an early stage, some information can be sourced from external entities or approximated using internal metrics.



Remuneration: "Issuer Pays" Vs "Subscriber Pays" model

"Subscriber Pays" is the most used fee model for ESG rating and data products. Potential risks of conflict of interests can be led by:

- **Disadvantage for smaller investors**, who have limited ability to subscribe to multiple product packages. ESG ratings providers are increasingly publicly providing their scores.
- **Pressure for the provider** to prioritise quantity of information over quality of information.

The revenue mix between the two models has been stable for several years.

A shift toward greater use of **"issuer pays"** could occur in the ESG ratings as result of upcoming regulation and evolving market practices.

ESG Ratings and Data Product Providers 2/3

Methods Used in the Industry 1/2

The methodological approaches are very diverse and, combined with availability, quality and comparability issues, result in low correlation and high divergence in ESG ratings and data products among providers.

1 Interactions with companies

One of the most significant sources for providers is the **information** gained from entities subject of ESG ratings and data products, either engaging with them at a late stage of the rating process or in a more continuous relationship, e.g., employing questionnaires. The manner of gathering information depends on the **business model** or/and proprietary methodologies of providers.

2 Methodological approaches and transparency

Some of the differences in methodologies among providers are:

- **data collection**, given the combination of information from different sources, such as public information, questionnaires or data produced or gathered by third parties through subscriptions or partnerships;
- data used may be presented as collected (raw), aggregated, processed or estimated;
- processes for **verification and update** of data: the information collected may be supplemented, specified or corrected through discussions with the assessed companies, but also a lack of reporting can either lead providers to use industry averages or to negatively assess the company;
- weight given to **quantitative and qualitative** analysis;
- **number** of data points, indicators or KPIs used to measure an issue and the **weighting applied** between different pillars and different sub-categories and indicators;
- **ratings finality**, which can focus on performance or risks, or have different approaches to materiality.

Moreover, little transparency can exist about methodologies for users of these products.

ESG Ratings and Data Product Providers 3/3

Methods Used in the Industry 2/2

3

Use of sector-specific methodologies

Providers use **sector-specific** methodologies and risk assessments. The majority use both general and sectoral metrics in their assessments, weighting them in different ways depending on the final product.

The nature of the indicators or criteria used also depend on which **ESG criteria** is applied: there is a general consensus regarding governance (G) criteria, while social (S) and environmental (E) criteria are applied in a less universal way.

4

Use of data collection tools

The implementation and present and future use of **machine learning** (ML) and **artificial intelligence** (AI) techniques is heterogeneous. Even if at a prototyping/pilot stage of deployment, AI and ML have a role in simplifying the data compilation process, in assessing market sentiment and behavior towards ESG issues and in providing their estimates.

5

Conduct of information gathering exercises by ESG ratings and data products providers

Information gathering practices depend on the nature of the ESG-related information and the acquirement channel. Information gathered through public sources should pass a “**quality-check**” stage, which can include: plausibility check, incoherencies screening, statistical and logical checks, checks against other sources and deviations against peer groups or previous years. When potential incoherencies are flagged, ESG ratings and data products providers generally favored dialogue with the assessed entities to confirm or inform the KPIs/metrics.

6

Benchmarking against other providers

Since the methodologies and product differences make a benchmarking for the products performances not feasible, ESG ratings and data products providers did not compare their own analyses with those of their competitors.

03

Private and Public Users of ESG Ratings and Data Products

Variation of Objectives for Using ESG Ratings and ESG
Data Products

Reliability of ESG Ratings and Data Products



Private and Public Users of ESG Ratings & Data Products 1/2

Just in Time

Variation of Objectives for Using ESG Ratings and ESG Data Products

Objectives of using ESG ratings and ESG data products	
ESG Ratings	ESG Data Products
Manage sustainability-related risks or opportunities	
Design and oversee sustainable products	Meet compliance with CSR policy
Guide engagement strategies that drive positive change in the invested companies	Negative screening (e.g., products that provide names of companies producing weapons)
Guide corporate sustainability initiatives	Offer sustainable investing products
Report to clients	Meet regulatory reporting requirements
Monitor external asset managers as trustee by assessing the exposure of ESG and climate risks	Analyze environmental impacts (e.g., GHG emissions, carbon intensity, monitoring the alignment of the financial portfolio to the Paris Agreement)

Private and Public Users of ESG Ratings & Data Products 2/2

Just in Time

Reliability of ESG Ratings and Data Products

Reliable ESG ratings and data products are important, particularly for users such as institutional investors to inform their investment decisions. However, they do **not implement verification processes** on raw ESG data underlying ESG ratings or ESG data products because such processes are **resource intensive** and may **not** be **possible with available information**.

There are generally similar factors impacting **reliability** of ESG ratings and ESG data products: **the lack of transparency of methodologies**.

The lack of transparency around external ESG rating methodologies is a key factor in **encouraging** users **to build proprietary rating methodologies**.

External ESG Ratings vs Internal ESG Ratings

The wholesale adoption of third party ESG ratings and their methodologies might **not align with their investment strategies**, but using external ESG ratings could **save them time** with regards to their own analyses

Users encouraged **third-party assurance** which would increase the reliability of the data.

Users tend to conduct an **assessment on** the ESG ratings or ESG data products **providers** rather than on the ESG ratings and data products.

They also indicated a preference **to rely on externally provided ESG data** from providers rather **than** externally provided **ESG ratings**.

Often users do not assess **external** ESG ratings **against** their **own in-house** ESG ratings because of the **different methodologies** used.

04

Companies and ESG Ratings and Data Products Providers

The Level of Interactions
Potential Conflicts of Interest



Companies and ESG Ratings & Data Products Providers 1/2

Just in Time

The Level of Interactions

Generally, there are three phases during which companies can interact with ESG ratings and data products providers, below the challenges faced by companies in each of them:

1 | Data Collection

- **Time consuming** to respond to questionnaires of differing **frequency** and **focus**.
- **Limited** forward **visibility** on receipt of requests for information from providers.
- Lack of **explanation** for questions being addressed to covered entity.

2 | Data Assessment

- Lack of **transparency** of the rating or data product methodology and criteria (the “**black-box**”; ESG factors, weight, absolute and relative scoring).
- **Change** of rating or data product **methodologies** without notification.

3 | Pre-publication

- Lack of possibility to get the **final report for free** making it difficult for the company to provide comments or corrections in a timely manner.
- Lack of opportunity to amend **incorrect information**.
- **Risk of investment decision** based on **inaccurate information** without review in advance of publication.

Companies and ESG Ratings & Data Products Providers 2/2

Just in Time

Potential Conflicts of Interest

In the interaction between companies and ESG ratings and data products providers sometimes there could be unexpected situation that could bring to potential **conflicts of interest**:



This could result in conflicts of interest where the consulting side of business may **provide information to the company** to allow said company **to gain an advantage in terms of receiving a good rating** or data product outcome from the ESG ratings or data product side of the business.

However, some global ESG ratings and data products providers are **separating** the function between **ESG ratings or data products and indices** to ensure their **independence** and **transparency**.

05

Final Recommendations

ESG Ratings and Data Products Providers' Point of View

Users' Point of View

Recommendations for Authorities Concerning ESG
Ratings and Data Products

Recommendations for ESG Ratings and Data Products
Providers

Recommendations For Market Participant Users of ESG
Ratings and Data Products



Final Recommendations 1/5

ESG Ratings and Data Products Providers' Point of View

IOSCO asked ESG ratings and data products providers to identify practical steps that could be taken to improve the usability and reliability of the information entities currently disclose:

There could be **more dialogue** between entities and ESG ratings and data products providers to understand when ESG ratings and data products will be subject to review/update to ensure both are aware of when engagement may be beneficial to address information gaps, or errors/omissions in ESG ratings and data products.



Entities could provide **more transparency about the timing** of disclosures and dialogues with ESG ratings and data products providers. For example, if at the start of the year, entities were to publish a calendar for when and where their ESG disclosures were to be made, this would help ESG ratings and data products providers align their review frequencies with the availability of information.



Entities could use one existing report as their primary form of ESG disclosure, such as an **annual sustainability report**. This would help place the reporting of ESG data on par with financial data.



Entities could work to ensure consistency of the KPIs referred to in these reports, for example by making clear where figures are being restated from a previous year, making clear the scope of the figures that are being presented, and providing **time series information** where possible.



Final Recommendations 2/5

Users' Point of View

IOSCO believes that there are some areas that could be improved from the users' perspective:

1

Reliability of raw ESG data

Given that the quality of raw ESG data relies to a large degree on the quality of corporate disclosure, most users expect that improvements in the quality of corporate disclosures would contribute to enhancing the consistency of ESG ratings and data products.

2

Lack of transparency

For ESG data products, data collection, frequency and verification will impact data quality. Lack of transparency on the process of developing ESG ratings and ESG data products could make it difficult for users to understand and interpret providers' outputs.

3

Reliability of ESG ratings

Where ESG ratings and data products providers also receive fees related to other services such as consulting services from entities, potential conflicts of interest could arise from such interplay of services.

4

Communication between ESG ratings and data products providers and

The seeming lack of opportunity given to entities to correct any errors could lead users to make investment decisions based on erroneous information.

Final Recommendations 3/5

Recommendations for Authorities Concerning ESG Ratings and Data Products

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**.

Recommendations on how ESG ratings and data products providers could consider interacting with entities subject to assessment:

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.

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.

Final Recommendations 4/5

Recommendations for ESG Ratings and Data Products Providers

They 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** and to help ensure their decisions are **independent, free from political or economic interference**.

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

They 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.

They 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.

Final Recommendations 5/5

Recommendations for Market Participant Users of ESG Ratings and Data Products

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.

Recommendation on how covered entities could consider interacting with ESG ratings and data products providers

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.

Sources and Literature

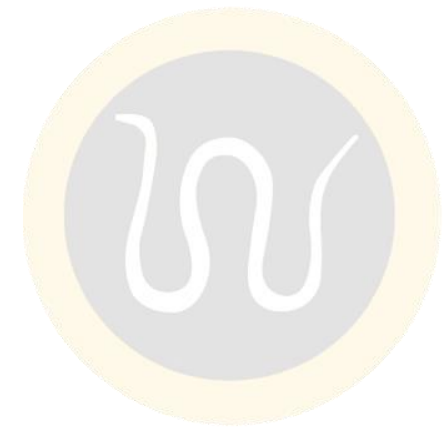
[01] **The Board of the IOSCO** Environmental, Social and Governance (ESG) Ratings and Data Products Providers Final Report, November 2021.



Company Profile

Iason is an international firm that consults Financial Institutions on Risk Management. Iason integrates deep industry knowledge with specialised expertise in Market, Liquidity, Funding, Credit and Counterparty Risk, in Organisational Set-Up and in Strategic Planning.

Fontana Roberta



This document was prepared in collaboration with Filippo Corti, who at the time was working for Iason Consulting.

This is an Iason creation.

The ideas and the model frameworks described in this presentation are the fruit of the intellectual efforts and of the skills of the people working in Iason. You may not reproduce or transmit any part of this document in any form or by any means, electronic or mechanical, including photocopying and recording, for any purpose without the express written permission of **Iason Consulting Ltd.**

www.iasonltd.com