Frankfurt,
6 September 2021

**BVI position on the IOSCO Consultation Report on ESG Ratings and Data Products Providers**

BVI[1] and its members are committed to the goals on facilitating sustainable growth, i.e. to shifting capital flows in order to accelerate transition to a more sustainable economy. The market for sustainable funds in Germany has experienced fulminant growth in the recent past. Funds that are classified as sustainable account now for EUR 361 billion on behalf of German investors at mid-year; this positive development is driven to a large extent by net inflows in retail funds. Compared to the end of the first quarter, assets have increased by eight percent. Moreover, the EU and German legal requirements to deal with sustainable risks are becoming stricter.

Asset managers use internal and external research for analysing their sustainable investments or risks. According to a membership survey, most of them use as their sustainability data basis providers of ESG ratings, followed by labels, benchmarks and other standards (such as ISO). The growing importance of ESG data, research and rating services, is reflected by the market concentration in this area which has significantly increased over the last years, due to strategic acquisitions following the drive to ESG regulation in financial services. All leading ESG data and research providers (such as MSCI, Morningstar - which acquired Sustainalytics in 2020, and Vigeo-Eiris, the biggest according to market share) are now either headquartered in the US or owned by US company groups with the exception of ISS ESG belonging to Deutsche Börse. This situation has implications for the quality and reliability of data, since investors and financial market participants need to rely on ESG research and qualitative assessments of ESG aspects as basis for ESG ratings that might not fully incorporate and take into account the development of the sustainable finance regulations, enacted e.g. in the EU. This is particularly relevant in relation to investments outside the EU, where EU investors will have difficulties to rely on corporate disclosures, which do not meet the EU data and disclosure requirements. With increased ESG regulation also in the Americas and Asia this outcome cannot be deemed satisfactory from a global policy perspective.

We therefore propose that global policy makers should urgently act in order to introduce a global standard for ESG reporting by companies. Such standard will significantly improve quality and availability of ESG data and consequently, will help to overcome the current dependency of data users on commercial data providers globally. A common reporting standard should reflect to the greatest possible extent the prevailing international standards for reporting of non-financial information. It should pertain to all ESG data requested by investors, including data on sustainability risk and opportunities, adverse impact of a company's business activities and the Taxonomy. The scope of standardised reporting should as a starting point cover all large companies seeking to raise capital via capital markets including foreign issuers that are listed on an exchange within a IOSCO jurisdiction. BVI supports the establishment of a new International Sustainability Standards Board (ISSB), to be set up in Frankfurt by the International Financial Reporting Standards Foundation (IFRSF) in time for the COP-26 Conference in November 2021. The ISSB would be well placed to harmonize global non-financial reporting taking into

[1] BVI represents the interests of the German fund industry at national and international level. The association promotes sensible regulation of the fund business as well as fair competition vis-à-vis policy makers and regulators. Asset Managers act as trustees in the sole interest of the investor and are subject to strict regulation. Funds match funding investors and the capital demands of companies and governments, thus fulfilling an important macro-economic function. BVI's 116 members manage assets some EUR 4 trillion for retail investors, insurance companies, pension and retirement schemes, banks, churches and foundations. With a share of 27%, Germany represents the largest fund market in the EU. BVI's ID number in the EU Transparency Register is 96816064173-47. For more information, please visit www.bvi.de/en.

BVI
Bundesverband Investment
und Asset Management e.V.

Contact
Phone +49 69 15 40 90 0
www.bvi.de

BVI Berlin
Unter den Linden 42
10117 Berlin

BVI Brussels
Rue du Trône 14–16
1000 Bruxelles

BVI Frankfurt
Bockenheimer Anlage 15
60322 Frankfurt am Main

Executive Board
Thomas Richter CEO
Rudolf Siebel MD

account the regulatory requirements applicable to investors and their asset managers when assessing portfolio companies in the various IOSCO jurisdictions from a sustainability perspective.

Regarding the operating conditions of ESG data providers, policy makers should closely monitor the increasing market concentration which is reflected in the pricing and license power of ESG data providers. In the last years, data providers have overloaded the market with their products. The pricing and licensing frameworks remain opaque, depending largely on the combination of data modules and the size of (ESG) assets under management of the clients. Action should be taken to improve transparency of pricing and license frameworks and assessment methodologies that should adequately reflect the future regulatory environment for sustainable finance.

EFAMA (European Fund of Asset Management Associations) and ICSA (International Council of Securities Association) published for IOSCO a Global Memo on Benchmark Data Costs, identifying the main challenges arising from the increased use of (including ESG ) benchmark data over recent decades and the imposition of increasingly complex and overpriced data licenses, which cover all types of data usages along the whole value chain of the financial services industry:

https://www.efama.org/newsroom/news/key-recommendations-fair-benchmark-data-costs-efama-icsa-global-memo-benchmark-data

Financial benchmarks and indices, including ESG, are fundamental to the functioning of financial markets as they are a valuable tool, helping market participants to set prices, measure performances, or work out amounts payable under financial contracts or instruments. Due to the growth of data usage, also ESG index and data providers have refined their licensing models and now cover the whole value chain of an asset manager. We are concerned that many data, and especially ESG index companies have great market power and can unilaterally set contractual conditions, since their financial services clients usually cannot easily operate their products without referring to the leading benchmarks. Given the importance of the provision of benchmark data to the well-functioning of financial markets the associations make a series of recommendations to ensure that benchmark data is made available to users at a fair price. The recommendations which could be implemented by the ESG data and index providers themselves are the following:

- **Impose a cost-based licensing mechanism:** Any benchmark data license costs should in principle be based only on the incremental/ marginal cost of providing and distributing a given data service plus a reasonable profits margin.

- **Impose transparency on costs and prices:** In order to reduce disputes related to license fees, users should have access to meaningful written information, which enables the reader to recalculate the actual costs based on the applicable pricing methods. This should include cost calculation methods as well as the guidelines on the allocation of fixed and variable costs, including the cost of third parties and the costs of the provision and distribution of benchmark data offerings.

- **Impose best practices on high impact data licenses:** Certain high-impact benchmark data license practices, which have significant negative consequences for end clients and financial markets should be subject to stricter controls. For example, the practice of data cut off should only be applied following a court or court of arbitration judgement.

- **Clear responsibility for index calculation errors:** There is a pressing need to hold index administrators responsible for any calculation errors and recognize how integral financial indices impact the implementation of investment management strategies - especially for index-tracking ones (like ETFs) - and how critical index quality is to their success for investors.

- **Keep data unbundling:** The user side of benchmark market data should only pay for data they are interested in rather than being forced to buy additional services. Benchmark data providers should always inform customers that the purchase of the benchmark is available separately from the purchase of additional data (for example license for constituents). Furthermore, benchmark data providers should not condition the purchase of individual benchmarks to the purchase of a broader range of benchmarks (in which there may be little interest).

- **Improve transparency**: Data users have concerns about the inventiveness of benchmark providers in creating new use cases or categories of license. Due to a lack of standardization for license concepts, fund management companies and banks do not have the ability to compare the license models across different index providers. More transparency, such as public pricelists on all data products and services , harmonized templates and standardization of definitions of key terms and concepts used in license data agreements, would be helpful in better understanding the criteria for such use cases and the avoidance of paying several times over for the same data.

We strongly encourage all ESG data and benchmark providers to adhere on a voluntary basis to the key recommendations as soon as possible. Such action could be initiated by way of an open dialogue with the major data providers and must not necessarily entail regulatory intervention.

With regard to the IOSCO recommendations for consultation, we would like to remark the following:

**Recommendation 1:** Regulators may wish to consider focusing more attention on the use of ESG ratings and data products and ESG ratings and data products providers in their jurisdictions.

We agree with IOSCO’s assumption that sustainability and climate-related data and scores suffer from a lack of standardisation and comparability. This also applies for the integration of ESG factors into credit ratings by credit rating agencies (CRAs). Even though there has been some improvement regarding the overall availability of ESG data in the last years, the persisting lack of comparability and reliability has still fundamental implications for data users, i.e. investors, companies and researchers. Directly reported company data is generally not usable in practice due to the lack of comparable and standardized data, a single access point and the necessity to perform quality checks on the reported information. This gap is currently being filled by commercial data vendors experiencing rapidly growing business opportunities parallel to the increasing regulatory requirements for the processing of ESG data for the purpose of internal processes (risk management, investment due diligence) and external client and regulatory reporting by financial market participants. Indeed, market concentration in the ESG data business has significantly increased over the last years, in particular due to strategic acquisitions. All leading ESG data and research providers with the exception of ISS ESG are now either headquartered in the US or owned by US company groups. This situation may become problematic in a twofold respect:

- It may have implications for the quality and reliability of data, if European investors and financial market participants needed to rely on ESG research and qualitative assessments of ESG aspects as basis for ESG ratings that might not fully incorporate and take into account the development of the EU sustainable finance regulations. This is particularly relevant in relation to investments outside the EU, where EU investors will most probably not be able to refer to corporate disclosures, since such disclosures will not meet the EU requirements. This potential outcome cannot be deemed satisfactory from a general policy perspective.

- It may further strengthen the pricing and licensing power of ESG data providers. In the last years, data providers have overloaded the market with their products. The pricing frameworks remain opaque, depending largely on the combination of data modules and the size of (ESG) assets under management of the client. A mid-sized to large fund manager will spend between EUR 200,000 and 400,000 per year for a comprehensive set of ESG data. Given that the amount of required data will grow in view of the pending implementation of ESG disclosure duties, we expect this cost to rise substantially in the future driven by global regulation. Additional cost for acquisition of EU-Taxonomy-relevant data can be estimated with EUR 50,000 for the currently required set of indicators. These expenses represent a significant burden especially for small and medium-sized asset managers and asset owners such as pension funds. More competition in the ESG data market would be helpful for raising efficiency as well as product quality and lowering costs.

In order to remedy this situation, **policy makers should urgently take action in order to introduce a global standard for ESG reporting by companies.** We trust that new frameworks will lay the foundation for the introduction of uniform metrics and reporting standards that should significantly improve quality and availability of ESG data and consequently, will help to overcome the current dependency of data users on commercial data vendors. A common reporting standard should reflect to the greatest possible extent the prevailing international standards for reporting of non-financial information to be set up by ISSB. It should pertain at a minimum to all regulatory imposed ESG data requested by investors, including data on sustainability risk and opportunities, adverse impact of a company's business activities and the Taxonomy. The scope of reporting should also be extended to cover all large companies seeking to raise capital via capital markets as well as non-EU issuers that are listed on a regulated market within the EU and central banks, including the ECB highlight the situation as an impediment to the consistent use of ESG data by financial institutions and market participants and stresses that unreliable ESG data and ratings limit users in their capacity to conduct granular financial risk analyses.

**Regarding the operating conditions of ESG data vendors, all policy makers should closely monitor the increasing market concentration. Action should be taken to improve transparency of pricing and license frameworks as described above and assessment methodologies that should adequately reflect the future regulatory environment for sustainable finance. Such action could be initiated by way of an open dialogue with the major data providers and must not necessarily entail regulatory intervention.**

Moreover, policy makers could collect annual information on pricing, licenses, costs and revenues per types of ESG ratings and ancillary services in addition to fees and costs for rating related products and services sold by other entities within the group. Collecting information on these items would lead to a better understanding of the services provided by rating agencies and their entities within the group. In our understanding, this explicitly involves transparency of the interaction with related entities of the rating agencies to avoid that these entities do not conflict with the non-discrimination and cost-based/cost-related principles laid down in the various national regulations.

**Recommendation 2:** ESG ratings and data products providers could consider issuing 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.

As users of ESG ratings and data products, asset managers are interested in a well-functioning and transparent rating and data product market. The main challenge in assessing ESG risks for the purpose of risk management or investment decisions is that no global standards exist yet, not much empirical data is available on a historical basis and with respect to comparability and reliability, and the time horizon differs between the short-term view in assessing the existing financial risks and the long-term view in assessing the ESG risk. Data on long-term risk aspects is still globally scarce. Identification of a specific exposure of a global portfolio to ESG risk will thus be a challenging exercise.

Moreover, in the absence of a consistent set of publicly available corporate-level information, the metrics developed by market data providers seek to consolidate the (limited) quantitative and qualitative environmental information provided by companies. The ECB highlights that situation as an impediment to the consistent use of ESG data by financial institutions and market participants and stresses that unreliable ESG data and ratings limit users in their capacity to conduct granular financial risk analyses. Therefore, the capability of investors to account for ESG risk within their risk management arrangements or investment decisions depends to a great extent upon the availability of public, transparent, relevant and reliable data related to ESG considerations.

Certain requirements on the price and license framework disclosure as detailed above could be helpful to improve the transparency of ratings or data if fees charged by these providers to their clients for the provision services are not discriminatory and are based on actual costs. Therefore, it is of utmost importance that supervisory authorities have an overview of the costs and revenues charged to identify possible risks and violations. Our members continuously complain about excessive fees charged and not transparent licensing models offered by data providers.

**Recommendation 3:** ESG ratings and data products providers could consider ensuring their decisions are, to the best of their knowledge, independent and free from political or economic pressures and from conflicts of interest arising due to the ESG ratings and data products providers' organizational structure, business or financial activities, or the financial interests of the ESG ratings and ESG data products providers' employees.

**Recommendation 4:** ESG ratings and data products providers could consider, on a best efforts basis, avoiding activities, procedures or relationships that may compromise or appear to compromise the independence and objectivity of the ESG rating and ESG data products provider's operations or identifying, managing and mitigating the activities that may lead to those compromises.

In the EU, credit rating agencies are already supervised and subject of regulation. This approach was designed to enhance the integrity, responsibility, good governance and independence of credit rating activities to ensure quality ratings and high levels of investor protection. In our view, this framework would also apply to them if they provide ESG ratings being part of their credit rating assessments.

However, we see the need for further monitoring in the area of concentration risks and dependencies arising from activities of (critical) data providers which are not subject of supervision and whose failure could have a significant impact on the financial market. Without secure access to their data and services, operational resilience of financial services in general and in specific cases also financial stability is at risk. Therefore, (digital) operational resilience includes also (financial market) data sources and distributors.

**Recommendation 5:** ESG ratings and data products providers could consider making high levels of public disclosure and transparency an objective in their ESG ratings and data products, including their methodologies and processes.

According to academic studies, the main issues with ESG scores seem to be systematic differences between methodologies of data providers regarding the indicators they use to measure ESG factors as well as their weights and scope (see for example, „Aggregate Confusion: The Divergence of ESG Ratings“, MIT Sloan School of Management, August 2019). This implies that the investment decisions made upon these scores might be biased. We therefore request full transparency about the rating/scoring methodologies used by data providers. Changes to the methodologies should also be made transparent and consulted beforehand with clients.

Another drawback of ESG scores though less relevant than reliability, is that, alike credit ratings, the information that ESG-scores provide is backwards oriented and does not allow for a forward-looking assessment of ESG risks and opportunities.

**Recommendation 6**: ESG ratings and data products providers could consider maintaining in confidence all non-public information communicated to them by any company, or its agents, related to their ESG ratings and data products, in a manner appropriate in the circumstances.

We support this recommendation.

**Recommendation 7:** Financial market participants could consider conducting due diligence on the ESG ratings and data products that they use in their internal processes. This due diligence 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.

In general, the increased availability of large volumes of financial data is influencing the assessment of investability and risks (including ESG risks) of financial instruments or entities. The large volumes show the diversity of qualitative and quantitative valuations. This leads to increased requirements on handling the large data volumes regarding e.g. the actuality and the validity and also on human capital for managing and using the data. The volumes and the time of the data availability will be used to develop early forecasts of e.g. creditworthiness and accurate assessment of ESG risks. The asset management area is developing tools to cope with the increased digitalization of the industry in terms of cloud computing, advanced analytics, mobile computing and robo-advice.

Asset managers in the EU are already obliged to ensure a high standard of diligence in the selection and ongoing monitoring of investments, in the best interests of the investors of the portfolios they manage and the integrity of the market. In principle, our members use data products as only one parameter when making their investment decisions. They may only make decisions, if they have the appropriate professional expertise and knowledge of the assets in which they are invested. They have to ensure that the managed portfolio is only invested in assets whose risks can be adequately assessed, monitored and managed by the risk management process adopted by the company. In order to ensure that investment decisions are carried out in compliance with the set investment strategy and risk limits of the investment fund. EU based investment management companies are also obliged to establish and implement written policies and procedures on due diligence. Moreover, before carrying out investments, management companies are obliged to take into account (where appropriate) the nature of the foreseen investment, formulate forecasts and perform analyses concerning its contribution to the fund‘s portfolio composition, liquidity and risk and reward profile. These analyses are supported by reliable, updated and meaningful information, both in quantitative and qualitative terms.

The individual assessment of the value or creditworthiness of financial instruments or entities is part of the overall risk management process of the investment management company and serves today as a principle against over-reliance on credit ratings. This process involves, in the light of the principle of proportionality, the assessment of any risk of each relevant assets invested by the investment funds (including the creditworthiness) and the establishment of an internal risk limit system for any relevant risk (including ESG risk) on asset and fund level. In practice, the risk management function is obliged to establish and implement quantitative or qualitative risk limits, or both, for each investment fund managed by the investment management company, taking into account all relevant risks (including ESG risks).

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

**Recommendation 9:** 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.

**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 regulatory and other legal requirements in their jurisdictions.

We do not opine on this point because asset managers rely to ESG ratings and data from a user perspective and are not themselves usually subject to assessment by rating agencies or data product providers.

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