FMSB
FINANCIAL MARKETS STANDARDS BOARD

Spotlight Review

ESG Ratings

July 2022

Financial Markets Standards Board

Financial Markets Standards Board Limited (FMSB) is a private sector, market-led organisation created as a result of the recommendations in the Fair and Effective Markets Review (FEMR) Final Report in 2015. One of the central recommendations of FEMR was that participants in the wholesale markets should take more responsibility for raising standards of behaviour and improving the quality, clarity and market-wide understanding of trading practices. Producing guidelines, practical case studies and other materials that promote the delivery of transparent, fair and effective trading practices will help increase trust in wholesale markets.

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Introduction

The rapidly growing and developing market for ESG-related products and services, the desire of financial institutions to assess and manage their exposure to ESG-related risks and sustainability impacts, and an increasing regulatory focus have heightened the importance of, and demand for, ESG ratings. ESG ratings aim to assess the profile of a company, country, or financial product for its ESG impacts and/or its ESG risks and opportunities[1]. They play a key role in transforming unprocessed data into an overall score, in addition to in-house analysis, that investors may use as a contributing factor in their investment decisions.

ESG ratings assist the development of a healthy market ecosystem by providing an additional and external source of due diligence and expertise, and potentially attracting newer/smaller investors to the ESG space. However, their prominence as a signal also means that ESG ratings have real impacts on issuers and investors. Transparency, accountability, and management of potential conflicts of interest are crucial to ensure that their important informative role in the markets is fair and effective.

This Spotlight Review aims to facilitate additional disclosure and transparency of ESG ratings methodologies and data collection processes, in order to enhance user understanding of ESG ratings and facilitate comparability across rating providers in wholesale financial markets. It is acknowledged that these disclosures must be proportionate to the capacity of both rated entities and rating providers, and commercial sensitivity. The Review builds on an existing body of work produced by regulators, standard-setters and industry participants and it focuses on issues identified in the following areas:

- Output/Objectives of ESG ratings
- Data inputs
- Methodology
- Post-assessment rating process

Scope: The focus of this Spotlight Review is on external ESG issuer rating methodologies for companies produced by third party commercial ESG rating providers, although some of the high-level principles may be equally applicable to other types of issuers (including sovereign issuers). The Spotlight Review does not consider internal scores and proprietary rating methodologies developed by users[2]. Credit ratings are considered distinct from ESG ratings and are outside the scope of this Review, though many "traditional" credit agencies also provide ESG ratings, which are included. The scope of this Review also does not include ESG fund ratings, which are designed to measure ESG characteristics of a fund's underlying holdings.

In considering these issues, it is acknowledged that a balance must be struck between rating providers maintaining confidentiality of their data collection tools and proprietary methodologies while providing sufficient transparency to support fair and effective ESG markets.

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Summary

There are varied use cases of ESG ratings: Market participants, in line with their activities, use ESG ratings in different ways. Investors may use the outputs as a factor in informing capital allocation decisions, or for reporting, alignment with global frameworks, regulatory compliance, integration, (thematic) impact investment, or stewardship and engagement strategies. Investors may also use information regarding serious controversies included in an ESG rating (in particular, where these are 'red flag' or 'severe' controversies) to create 'exclusion lists' to filter out firms who have engaged in specific controversial behaviours from an ESG perspective, for example, causing an environmental disaster or allegations of corruption. Issuers may use their rating to guide internal decision-making and benchmark their own sustainability performance while lenders may look at ESG ratings when reviewing their loan portfolio from an ESG or climate perspective. See Figure 2 below for a diagram of typical use cases across the ESG ratings market.

However, as a relatively nascent product, there remain issues identified with ratings, predominantly around disclosure and market understanding: Recent regulatory publications have highlighted numerous issues with the ESG ratings market, from both rated entities and rating providers, that may impact the uses of ESG ratings outlined above, or send unclear ESG signals to market participants, including:

- Limitations in user understanding of the objectives of ESG ratings and the measurements/outcomes (including whether ratings are risk-based or assess "double materiality");
- Limited transparency and comparability of ESG methodologies (including the role of controversies, manageable vs unmanageable risk and how data gaps are treated);
- Lack of robustness and quality of underlying data informing ratings, compounded by issues with limited or inconsistent corporate disclosure;
- Limitations in the engagement process between rating providers and rated entities (particularly in the context of correcting inaccuracies or disparities in the ratings)[3]; and
- Limited transparency around ratings being solicited or unsolicited[4].

Rating products may have different objectives: There is significant variation in what different ESG ratings seek to measure (the 'objective'). Increasing user understanding of ESG ratings' objectives is therefore important, with both the European Commission and IOSCO recommending that providers give greater transparency around the intended purpose of the rating, including its measurement objective[5]. ESG ratings may be aimed at measuring ESG risks (referred to as 'materiality') or ESG impacts (often referred to as 'double materiality')[6]. The concept of 'materiality' considers the risks that ESG factors pose to the company's financial bottom line by impacting the company's 'development, performance [and] position'[7], while 'double materiality' also considers the ESG impact of the company's activities on the outside world. Double materiality is becoming increasingly important, for example to investors who seek to understand and measure the climate impacts of their investment portfolios[8]. It can also be unclear whether an ESG rating is sector-based (assessing performance relative to the rated company's peer group) or an absolute score. The selection of the peer groups themselves can also be unclear. In absence of an industry standard on the parameters of a particular ratings product, a sufficient level of transparency on methodologies to allow market participants to understand their purpose is essential.

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Ratings diversity: Underpinning the issues identified above is a high level of diversity across ESG ratings for the same or similar entities. This is in part due to differences in how risks may be measured[9] and/or different weightings that rating providers attribute to different ESG factors[10], as well as differing subjective views on what 'good' ESG performance means. Ratings diversity is not itself problematic, provided there is adequate market understanding of the reasons for such diversity. However, limited transparency of methodology in addition to diversity can impair user understanding and therefore create difficulties with evaluating the basis for an ESG rating undermining the overarching objective of ESG ratings. This paper does not seek to standardise or harmonise methodologies, as it is recognised that the ESG market is diverse, subjective judgment varies, and accordingly, some level of diversity of ESG products is beneficial. Instead, it aims to increase market effectiveness by increasing transparency of methodologies to better allow market participants to understand the basis for ESG ratings. It also aims to increase transparency of data collection processes so market participants can understand the timeliness of the data underlying the ratings, and issuers remain engaged.

The impact of controversies on an issuer's ESG rating can be material but little understood[11]: Often the role controversies play in ESG rating methodologies are not fully transparent, including the time horizon for relevant controversies to be considered in an ESG rating or the materiality threshold for controversies to be incorporated into ESG ratings and the degree to which a controversy is expected to create risk to an issuer's financial position. The impact of an ESG controversy may be significant and long-lasting as 'negative headlines stick in investors' minds'[12]. However, some issuers are concerned that the treatment of controversies under ESG methodologies may further exacerbate the duration of their impact. This paper suggests that users would benefit from greater clarity around threshold limits for controversies being incorporated into ESG ratings, guidelines around the duration of their impact, the timing of updates and conditions for a controversy being lifted or upgraded pursuant, for example, to remediation or time since the event.

Efforts to increase issuer ESG disclosure are likely to improve the quality of ESG ratings: The introduction of global disclosure requirements is likely to drive significant improvements in the quality and consistency of disclosures. The International Sustainability Standards Board (ISSB), created by the IFRS Foundation in November 2021, is intended to create global sustainability-related disclosure standards to encourage transparent, reliable and comparable reporting by companies on climate and other ESG-related matters, with guidance expected by the end of 2022[13]. Two Exposure Drafts on General Sustainability-Related Disclosures and Climate-Related Disclosures, were published for comment in March 2022[14]. At the request of the European Commission, the European Financial Reporting Advisory Group (EFRAG) is currently developing draft European sustainability reporting standards which revise the Non-Financial Reporting Directive (NFRD); on 21 April 2021, the EC adopted a proposal for companies in scope of the Corporate Sustainability Reporting Directive (CSRD) to report in compliance with these standards[15]. More comprehensive disclosure by issuers is key to improving the quality and robustness of data underpinning ESG ratings.

Greater transparency helps to drive market solutions independent of regulation: Given the increasing role that ESG ratings are playing in wholesale financial markets, it is important that transparency of the ESG ratings market is improved to promote user understanding and further aid comparability across providers. It is hoped that this will strengthen the market's trust in ESG ratings and, in turn, support the informed allocation of capital[16]. This paper recognises that market-driven solutions can help promote consistent standards that transcend national borders, and indeed, some market leading providers have already, or are in the process of, making one or more of the improvements that have been identified by market participants below.

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Definitions

For consistency, this Review takes the definitions of ESG ratings and ESG data from IOSCO and the European Commission directly.

ESG ratings – means the 'broad spectrum of external ratings products that are marketed as providing an opinion regarding an entity, a financial instrument or a product, a company's ESG profile or characteristics or exposure to ESG, climatic or environmental risks or impact on society and the environment that are issued using a defined ranking system or rating categories, whether or not these are explicitly labelled as 'ESG ratings'[17].

ESG scores are included within this broad definition. However, scores may not involve any additional substantial rating-specific analytical input from a rating analyst.

ESG data – means 'information on the environmental, social, economic and/or corporate governance exposures and the respective practices of companies. These data are typically gathered from company disclosures and collected in a database to make it easier for users to search for and access the information. These data may be presented to users 'raw' – as it was presented and collected from company disclosures; it may be 'aggregated' – where it is combined or collated from across numerous sources and expressed or presented in summary form; and it may be 'cleaned' – where it is processed in order to detect and correct (or remove) inaccurate records and where missing data is estimated or proxied from industry averages. Such data may relate directly to individual companies, but may also relate to individual assets, to countries or cities, to regulations or to many other aspects of industrial activity'[18].

Due to the limited standardisation of ESG reporting by companies, the disclosures can be found in annual reports or reviews, ESG or sustainability reports, company websites and non-financial climate disclosure reports.

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Market and regulatory context

What is the typical ESG rating process?

Each rating process can differ depending on the objective of the rating and the rating methodology employed by the provider, taking into account the industries in which the company derives revenue, as well as the geographical reach of its operations. However, at a high level, and assuming a rating methodology has already been established, most ratings tend to follow a similar process, outlined below[19].

1 Peer Identification:

Providers identify the peer group of the company being evaluated.

This is to ensure companies are evaluated against comparable companies within the sector, taking into account the industries in which the company derives revenue.

2 Identify Sustainability/ESG Issues and Indicators

Providers identify key issues relevant to assessing sustainability or ESG exposure (e.g., risk or impact) and then select specific indicators of performance against the identified issues, often with a view to using the indicators most material to the sector or industry relevant to the company being evaluated.

This step may contribute to ‘scope divergence’ (rating based on different set of attributes) or ‘measurement divergence’ (where rating providers use different indicators to measure the same attribute)[20].

3 Gather Data and Validate

Providers gather data relating to these indicators, generally from entities’ publicly available sources, such as ESG supplements or climate-related disclosures.

The initial data collection exercise usually uses artificial intelligence (AI) to scrape the data, which may then be subject to human review. The entities are contacted to review the gathered information within a given timeframe, depending on whether the rating is solicited or unsolicited.

4 Assess the Data

Providers assess the robustness and consistency of the data collected and make estimations if there are gaps in the data (often based on sector averages).

5 Final Scoring and Evaluation (Data Combined and Weighted to Produce Score)

Qualitative data points are quantified, and other data inputs are then weighed and calculated according to the specific rating methodology used.

There may be qualitative input from analysts. Many rating providers produce separate E, S and G sub-ratings as well as an overall ESG rating. This step may contribute to ‘weight divergence’ whereby rating providers take different view on relative significance of attributes and how heavily they should be weighted[21].

6 Publication and Review

Providers publish the rating.

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Unlike credit ratings, underlying data is generally only made available on an annual basis, though controversies are often incorporated on a more regular basis (such as through instantaneous or daily screening).

Figure 1 – the ESG rating process[22]

1. Peer identification
2. Identify ESG indicators and weighting
3. Gather data and validate
4. Assess data
5. Apply evaluation methodology to reach final score
6. Publication and review

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Use Cases

ESG ratings are used in a variety of ways by companies and market participants, though are one of many input factors, especially where ratings are used in decision making or informing strategy by participants in wholesale markets. An overview of the key uses of ratings by participants in wholesale financial markets is outlined in Figure 2 below. These use cases are becoming increasingly diverse as the types of ratings offered by providers are increasing due to user demand.

Figure 2 – Diagram of Potential ESG Ratings Use Cases by Market Functions

ESG rating provider

Provide ESG ratings

Provide ESG ratings

Data engagement and disclosure

Subscribes to issuer's ESG-linked financial services and products

Provides ESG ratings

Unlike credit ratings, ESG rating providers typically rate issuers and their products on behalf of investors, not the issuers

Lenders

Informs lending decisions:
- ESG profile considered alongside creditworthiness of entity
- ESG ratings may influence terms and pricing of sustainability-linked debt
- Evidence of enhanced yields tied to improved ESG governance

Provides loan finance

Issuers

Informs internal strategy:
- Guide sustainability performance/policies and company strategy
- Benchmarking (across peers and ESG rating provider universe)
- Link remuneration to ESG KPIs
- Guide to high level challenges for corporate treasurers

Trade execution

Guidance on engagement with rating providers

Intermediaries

Helps price discovery:
- Supports discussions with investors and peers with regard to comparability and performance
- ESG data supports KPI-linked instruments for historical evaluations and peer benchmarking
- Integration of ESG in equity/credit analysis (stock, sector, regional level)

Note: Growth market for sell-side and advisory institutions

Trade execution

Institutional investors (Agents)

Informs investment decisions:
- Understand ESG risk exposure and opportunities
- Increase exposure to ESG solutions*
- Credit analysis (credit risk function)
- Reputational impact (negative or positive)
- Guide to issuer engagement/priorities ('conversation starter')
- Controversy screening/exclusion lists

Sets monitoring processes and rules for portfolio construction:
- e.g. minimum rating thresholds for issuers
- Development of in-house ratings or scorecards (using ESG data from multiple providers)

Note: Fundamental analysts will have their own view on ESG ratings – used in fundamental investment process by asset managers and asset owners

Set and evaluate asset manager's mandates

Client reports

Asset owners (Principals)

Informs investment decisons:
- Assess company commitments to lower carbon economy
- Identify areas for further engagement
- Perform asset allocation
- Links to executive remuneration with regard to ESG performance
- Controversy screening/exclusion lists
- Monitor and review investment performances.
- Assess ESG risks

Note: Fundamental analysts will have their own view on ESG ratings – used in fundamental investment process by asset managers and asset owners

* Used to integrate ESG factors into the investment process to increase exposure to ESG solutions, including: ESG integration; Norms-based screening; Negative screening; Best-in-class screening; Sustainable thematic investing; Impact investing (see GSIA 2020 report) and Controversy screening.

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Regulatory background

There has been significant recent regulatory and legislative focus on ESG ratings. However, given the relatively nascent stage of the market for ESG ratings, the market remains broadly unregulated. A summary of the key existing regulatory and industry guidance and initiatives touching on ESG ratings is set out below.

Region	Initiatives
UK	• FCA published a Consultation Paper 'Enhancing climate-related disclosures by standard listed companies and seeking views on ESG topics in capital markets', June 2021. This paper considers the ESG data and rating landscape. FCA published a Policy Statement in relation to this in December 2021. • FCA refreshed ESG strategy and upcoming milestones, November 2021. Refreshed ESG strategy includes, among other themes, a focus on transparency in relation to climate change and wider sustainability and trust in ESG-labelled instruments and products. • HM Govt: Greening Finance: A Roadmap to Sustainable Investing, October 2021. Notes the importance of providers delivering ESG data and ratings transparently and states that the government will consider bringing providers into the scope of FCA authorisation and regulation in 2022. • ESG integration in UK capital markets, Feedback Statement FS22/4, June 2022. The FCA notes that it sees 'a clear rationale for regulatory oversight of certain ESG data and rating providers – and for a globally consistent regulatory approach informed by IOSCO's recommendations on ESG data and ratings'. A regulatory regime would focus on enhancing transparency of ratings and data products and promoting strong governance, conflicts management and systems and controls.

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Region	Initiatives
Europe	**European Commission** ● Action Plan for Sustainable Finance, 2018, studied sustainability ratings and research exploring the types of products that are provided in ratings and market research, the main players, data sourcing, transparency of methodologies and potential market shortcomings. ● Study on Sustainability-Related Ratings, Data and Research published, January 2021 (study referred to directly above). ● Strategy for Financing the Transition to a Sustainable Economy, July 2021 stating that it would take action to improve the availability, integrity and transparency of ESG ratings. ● EC issued a Request for Support to ESMA, January 2021 (referred to on page 5 of ESMA's Call for Evidence) and outlined in more detail below. ● Targeted Consultation on the Functioning of the ESG Ratings Markets in the European Union and on the Considerations of ESG Factors in Credit Ratings, April 2022. **ESMA** ● Letter to EC on the unregulated nature of ESG ratings and data assessments and the associated risks to investor protection, January 2021, including the lack of common definitions, comparability of ESG ratings and legal requirements around ensuring transparency of underlying methodologies, and potential risks of conflicts of interest depending on the providers' business model. Noted that these issues could lead to risks of capital misallocation, product mis-selling and greenwashing. ● Call for Evidence on Market Characteristics for ESG Rating Providers in the EU, February 2022, seeking evidence from ESG Rating Providers, users of ESG rating providers and entities covered by ESG rating providers with an aim to develop a more comprehensive picture of size, structure, resourcing, revenues and product offerings of ESG rating providers in the EU. Outcome of Call for Evidence published in June 2022. ● ESMA Sustainable Finance Roadmap: ESMA has highlighted that growing demand for ESG investments is not matched by adequate transparency and comparability on the 'real sustainability impact of the financial products available in the market, on the underlying sustainability profile of issuers and on the methodologies underpinning ESG ratings and data in general'. This may create risk of misrepresentation, wrongful disclosure and mis-selling of ESG-labelled products to final investors. **National competent authorities** ● AMF France and AFM Netherlands – Position Paper: Call for a European Regulation for the provision of ESG data, ratings and related services, December 2020.

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Region	Initiatives
Japan	**Japanese FSA** ● Technical Committee for ESG Rating and Data Providers set up in February 2022, focused on improving the quality and reliability of ESG ratings, with a code of conduct to follow.
India	**Securities and Exchange Board of India (SEBI)** ● Consultation Paper on ESG Rating Providers for Securities Markets, January 2022, the launch of a consultation to establish a regulatory framework for ESG rating providers. The aim is to improve transparency and comparability surrounding the metrics used in ratings.
International	**IOSCO** ● IOSCO Consultation Report on ESG Ratings and Data Providers, July 2021. ● IOSCO Final Report on ESG Ratings and Data Providers, November 2021. **Bank for International Settlements** ● Achievements and challenges in ESG markets, December 2021, noting the importance of investors responding to accurate ESG information and pointing to issues around divergence within ESG rating agencies, particularly around how to interpret firms' voluntary ESG disclosures. ● Deconstructing ESG scores: how to invest with your own criteria, March 2022. **OECD** ● ESG Investing and Climate Transition: Market Practices, Issues and Policy Considerations, October 2021, outlining challenges to ESG investing, in particular the lack of comparability of ESG ratings and the quality of data used for investment decisions. **SEC** ● Annual report noting increased review of ESG rating practices of credit rating firms, January 2022.
Industry	**IRSG** ● Report on ESG Ratings and ESG Data in Financial Services, 21 February 2022, including key recommendations relating to consistency, coordination and collaboration, transparency, data standardisation and investor protection. **AFME/ISDA** ● Response to ESMA's Call for Evidence, March 2022.

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Key issues in a typical ESG rating process

This section summarises the key issues relating to collection of data or the transparency of rating methodologies that have been identified in regulatory commentary to date, as well as areas highlighted by market participants. The issues are grouped by typical steps in the ratings lifecycle, albeit not all ESG rating providers will follow these steps.

Key steps in ratings lifecycle	Issues
Step 0: Establish Methodology	• **Limited transparency:** evaluation process perceived as a 'black box' with little information provided on evaluation methodology, including assessment criteria, weighting of different ESG indicators, definitions used, the objectives of the methodology, and whether absolute or sector-based scoring is used. • **Significant variation** in methodological approaches amongst providers. As outlined above, high levels of diversity can be caused by 'scope divergence', 'measurement divergence' or 'weight divergence'. Diversity of ratings is not of itself detrimental (and complete homogeneity of ESG ratings may not be desirable) but this is can hinder comparability and user understanding if there is not sufficient transparency around methodologies and data collection processes. • **Clarity on time horizon of the rating:** there can be limited clarity on whether assessment is backward looking or also includes forward-looking analysis. Forward-looking analysis is particularly important for climate projections or transition plans.
Step 1: Peer Assessment	• **Lack of clarity on peer assessment process:** some participants have noted a lack of clarity as to how a company's sector is decided and a lack of information on how peer analyses are updated to reflect ongoing sector developments.
Step 2: Identify Sustainability/ ESG issues and indicators	• **Lack of clarity on indicator identification process:** including the decision-making process for determining relevant indicators and how they are weighted. • **Limited understanding of ratings objectives:** there can be limited clarity on the intended purpose of different ESG ratings. The rating objective impacts the use cases and market understanding of the outputs. • **Clarity and consistency of purpose of ratings** should enable users, the public and other stakeholders to better understand what the rating is measuring and hence make more informed decisions.

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Key steps in ratings lifecycle	Issues
Step 3: Gather data and validate	• **Availability and completeness of data:** there may be gaps where ESG data is unavailable, often due to insufficient or inconsistent ESG disclosure by rated companies (which disclosure initiatives like ISSB and EFRAG are aiming to improve and harmonise over the coming years). Issues of disclosure can involve size bias, as larger companies typically have more resources to report ESG data, potentially impacting input scoring. • **Consistency:** ESG data is often located across different sources and formats (e.g. annual reports, corporate sustainability reports, webpages). Data collection and information gathering/engagement processes differ amongst providers[23]. This may create a risk that not all relevant data is captured, or outdated or incorrect data is used. • **Resourcing:** responding to private questionnaires is time and resource intensive, particularly when entities being rated are not informed ahead of time. As a result, entities may not provide robust responses and may leave data gaps that will filled by proxies or potentially assigned an unduly negative weighting[24]. This may also lead to size bias whereby larger firms with more resources to report on their ESG activities score more highly. Providing an indication of the relative importance of different data points to the ESG rating to companies is crucial for companies that may be resource constrained. • **Engagement:** lack of engagement with issuers throughout the data collection and assessment process increases the difficulty of understanding ratings output. Issuers may not have an opportunity to review the final draft before publication to address any mistakes or misunderstandings. • **Jurisdictional limitations:** extracting data from certain jurisdictions, such as the emerging markets, can prove difficult due to differences in approaches to disclosure. • **Timing alignment:** ratings updates are often out of step with sustainability reporting cycles and reporting periods across different sectors, which do not follow a regular rhythm (unlike financial reporting). There is often a time lag between when underlying data is published and the timing of the ratings assessment cycle, meaning that updates may need to be considered more frequently to capture the relevant data.

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Key steps in ratings lifecycle	Issues
Step 4: Assess the Data	• **Data gaps and use of "proxies":** data gaps or inconsistencies in ESG data disclosure by companies can lead to the use of assumptions, approximations, normalising factors or estimates to fill the gap or normalise the data, which can create various issues. This may decrease the relevance of the rating and mean that the rating is less accurate/reliable because the industry average figure may differ quite significantly from the actual data point[25]. Data gaps are more common in smaller/medium sized companies, private companies, and in emerging markets. • **Estimations:** Types of data estimations can also vary, and it may be helpful for rating providers to disclose whether they are using information/fact-based reasonable estimates, approximations on the company level from modelled data, or filling in industry averages, for example. • **Proxies:** There is confusion around the impact of proxies on ratings and the behaviour their use might incentivise. Could use of proxies incentivise companies who are performing less favourably than the industry average to rely on proxy data, or does non-disclosure negatively impact on the score, which would generally incentivise to more disclosure?[26] One participant noted their understanding was that if a company was not scoring well, it could either disclose more information or look to revise its strategy.
Step 5: Final Scoring and Evaluation Methodologies	• **Impact of analyst input:** there can be limited clarity on the role of analyst input. Analysts are not always sector experts, which impacts the quality of the output, given lack of specialisation. Not all ESG ratings will involve substantial rating-specific analytical input from a rating analyst. • **Lack of engagement between rating providers and issuers:** There have been frequent changes to methodologies without prior notification or explanation to the market. These changes are likely to increase as disclosure requirements and regulation evolve.

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Key steps in ratings lifecycle	Issues
Step 6: Publication and Review	• **Lack of engagement before rating publication:** There may be limited opportunities for an issuer to engage with a provider before a rating is published, limiting the ability to check the accuracy and context of the underlying data. Where an inaccuracy is noted, some providers fail to engage with the entity to address the error (either in a timely manner or at all). This is particularly the case for unsolicited ratings, which are more likely to rely on public sources/media scrapings which may be inaccurate, misleading, out of context or outdated. • **Frequency of ratings review:** It can be unclear how often providers review/update their ratings. Ratings may be based on outdated data or controversies which may not be updated in a timely manner or are not fact-based (e.g. based on newspaper articles) or no longer relevant. • **Errors:** once a rated company has been assessed, issuers may struggle to engage with providers to rectify errors in ratings in a timely manner, both before the rating is published or once it has already been published. Again, this is particularly the case for unsolicited ratings. There have been instances of providers not engaging with the issuer or a lack of transparency around how these errors are being addressed. Some issuers have found they have had to obtain a solicited ESG rating (paying a fee) to rectify the error, meaning that a corrected or updated report may not be available for several months. • **Timeliness:** once a rating has been published, it can be unclear how often rating providers undertake reviews of the underlying data to ensure the rating remains up to date and accurate. It is also unclear how long an 'old' controversy may impact the rating and how this might be weighted.

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Improving transparency

This section outlines key areas where ESG rating providers would welcome engagement from issuers, and market participants would welcome more transparency around ESG rating inputs, methodologies and outputs.

Ratings are an important part of the ESG ecosystem. They help market participants to understand the ESG profile and risks of particular issuers or instruments, so encourage the efficient allocation of capital. The rapid growth in the use of ESG ratings comes with greater calls for transparency in this area. Issuers need to be able to understand how their actions affect their ratings, otherwise engagement may be lost, the integrity of ratings might be damaged, and the transition to a 'greener' economy become less smooth. As a result, increased transparency and understanding of how ratings are calculated and the criteria or methodology used, is important.

The aim of increased transparency is not to standardise rating providers, as the importance of diversity amongst ratings methodologies and techniques is understood and valued by market participants. Rating providers that offered feedback on this Spotlight Review generally agree that improved transparency would be beneficial for the future of the market, to strengthen their integrity and encourage rated entities to act more consciously.

In response to calls for transparency, many rating providers have already begun to increase their disclosures, and some market leaders already operate at a high level of disclosure of both data collection and methodology. However, this transparency drive has not been coordinated across the market.

The list of disclosures provided in this Spotlight Review is a comprehensive list of possible disclosures that have been raised by participating organisations. It is not suggested that rating providers will be expected, or able, to provide disclosures on such a large number of data points for all their methodology types, and not all of the observations will be relevant to all ESG rating providers. Furthermore, many of the recommendations are at a granular level, and so it may be difficult for all rating providers to provide this detail. Rather, issuers seek sufficient information to understand their ratings; the table below is a menu from which data points could be chosen to achieve this.

It is important to note that the level of disclosure that can reasonably be provided by ESG rating providers will depend on the type and size of entity they are rating. For example, transparency for smaller entities, and those not under public ownership (therefore having lower reporting requirements) may prove more difficult. This means that there is unlikely to be a standard level of disclosure, as it will vary by ownership or jurisdiction. It is also acknowledged that disclosures should be proportionate to the complexity and nature of the ESG rating, and a balance must be struck between providers maintaining confidentiality of their data collection tools and proprietary methodologies and providing sufficient transparency to support user understanding. The "investor pays" model of ESG ratings also means that full transparency for non-subscribers (including issuers) may be difficult to achieve.

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Considerations for issuers

The accuracy of an ESG rating depends on the reliability of its data inputs. However, ESG rating providers face certain challenges when ingesting data inputs from issuers. The table below, drawing on recommendations and commentary in the IOSCO Final Report, highlights some of these challenges and considers the role that rated companies might play in facilitating an increase in the robustness of ESG ratings.

Challenges for ESG Rating Providers	Issue	Considerations for issuers
Consistency and structure of data inputs	• Rating providers often need to extract different data points from different sources (e.g. certain data points may be provided in a table or spreadsheet, others may be included in the middle of text, etc.)	• Disclosure of data in compliance with applicable disclosure frameworks produced by e.g. ISSB, TCFD and EFRAG (when introduced) and in a consistent and coherent manner. • Machine readability of data.
Disclosure across providers	• It is inefficient for issuers to disclose to rating providers on a bilateral basis, and increases the risk that disclosure is incomplete or inconsistent between providers.	• Making data disclosures more accessible by 'making sustainability information public and consolidating it in the minimum number of locations, with maximum visibility over previous and upcoming disclosures'[27] to improve efficiency and consistency of data disclosures across different rating providers. This will decrease gaps in data availability, help improve robustness of available data and increase efficiency of data collection process.
Data accuracy	• It is often unclear whether ESG data provided by rated companies has been adequately verified or reviewed.	• Improving engagement with rating providers to provide explanation of internal verification processes undertaken to ensure robustness of data, as well as clear delineation between external and internal audit.
Restated data	• There is often a lack of clarity on restated data used by rated companies. For example, where a rated company identifies a historic error in their data, it must restate the data point. This restatement may impact not only current data but also data points for preceding years. This is not always adequately flagged to the rating providers and is particularly important given evolving methods and standards.	• Providing greater transparency on when and why the data was restated/if the scores are using restated data.

Contents

Proposals for ESG rating providers

Field	Information	Possible information format[28]
Output		
Objectives	Clearly outline the objective of the rating (underlying purpose/intent of the rating – i.e. what the rating aims to measure), including: ● Level of materiality being assessed: o Single materiality (risk-based, assessing ESG risk to the company) o Double materiality (assessing risk to the company and the negative or positive impact of the company to the wider world)	Tag/Brief explanation
Scope of Environmental Assessment (only applicable to rated products)	● Label stating the scope of the assessment, for example: o Cradle to gate (partial life cycle assessment of a product from resource extraction to end of production phase) o Cradle to grave (full life cycle assessment of a product from resource extraction to use phase and disposal phase)	Tag/ Brief explanation
Sector-based or absolute	● Label stating whether rating is sector-based or absolute ● Where the rating is sector-based, provide an explanation of how changes within the sector are monitored and impact the rating ● How industry proxies are calculated, such as number of sources and geographic regions included	Tag/Brief explanation

Contents

Field	Information	Possible information format[28]
Output		
E, S and G pillars	• Label stating whether the rating is an E score, S score, and/or G score or equivalent, as a minimum level of granularity • Explanation of interrelationship between overall ESG rating and sub-ratings	Tag/Brief explanation
Typical use cases	• Indication of typical/intended use cases for ratings with this objective	Brief explanation

Field	Information	Possible information format
Input		
Source	Sources of qualitative and quantitative information of the data: • Publicly sourced (provided by the issuer in annual reports or produced by third parties, e.g. media articles) • Proprietary/confidential data purchased by providers; or • Private information provided by rated company	**List of sources reviewed and dates** Tag of the following: • Information that has been provided by the issuer • Information collected from secondary sources (not from the issuer) • Industry/sectoral proxies • How this information is being used (e.g. to inform industry approximations)
	Format of the source: • Such as financial statements, reports, web scrapings, media articles, issuer completed questionnaires	Tag (Separate categories for issuer, non-issuer and proxy)

Contents

Field	Information	Possible information format[28]
Input		
Source (continued)	Priority of data inputs (data hierarchy or 'waterfall'): ● Providing a 'waterfall of importance' or hierarchy to indicate which ESG issuers and/or data sources are prioritised by rating providers (similar to the hierarchy of data inputs contained in IOSCO's BMR Guidelines)	Numbered priority list or diagram
	Data oversight and verification processes: ● Explanation of the processes undertaken to verify data and any issues identified with data provided by the rated entity, including inherent risks in data collection ● Create a level of assurance or sign-off from the rated entity in relation to the accuracy of input information	Brief explanation
	Engagement by provider with issuer to collect data: ● Indication of whether there has been engagement from the rating provider with the rated company *(this information is also relevant to the 'unsolicited' rating row below)*	Tag and frequency of dialogue

Field	Information	Possible information format[28]
Input		
Timeliness	Time of data collection: ● When data was collected or last updated, and when next collection or update point will be (for both large overall reviews or interim smaller reviews for e.g. controversies) if not reviewed on an ongoing basis ● Overview of the assessment cycle (may vary within different sectors) and publication of ESG-related disclosure	Tag
	Time lag between date to which data relates and date of rating: ● Provider to outline guidance or explanation when data is seen as 'stale' or no longer relevant to the rating	Tag
	Time horizon of data: ● 'Evergreen' data (i.e. doesn't change from year to year), if any ● Based on the financial year just ended ● Based on data older than two years, if any	Percentage breakdown (diagram/chart): (1) any evergreen data points (2) any data from more than a year old

Field	Information	Possible information format[28]
Input		
Data collection tools	Manual or AI collection processes: ● Whether the data is collected manually or by AI processes	Tag
	● Percentage breakdown of how much of the score relies on manual vs AI processes	Percentage breakdown
	Confirmation of the verification process used to address inherent risks in data collection	Brief explanation
	For AI processes: ● Indication of what information will need to be machine readable	Brief explanation
	Assumptions underpinning AI data collection: ● What are the assumptions underpinning AI data collection (e.g. word selection by the algorithm) and are they industry specific? ● Impact of the assumptions underpinning the AI on the rated company	Brief explanation

Input		
Engagement between providers and rated companies for data collection	● Providing a standardised, publicly available questionnaire through a centralised website for rated companies to complete	Website form
	● Indication of whether there is a complete, partial or no response from corporate	Tag
	● Notification to issuers indicating anticipated timeframe of questionnaires (private or public)	Notification

Contents

Field	Information	Possible information format[28]
Processes		
Criteria selection	• Criteria used to assess issuers or products and relevant KPIs	• Brief explanation/List of core indicators • Percentage breakdown to indicate weightings, where appropriate • Flag if weighting deviates from peers • Flag if criteria has changed from previous report
	• Indication of alignment of KPIs to non-financial reporting standards	
	• Indication of the core set of key indicators used across entities in the same or similar sector	
	• Weighting of different criteria within an industry/sector • Where this is not able to be provided for proprietary reasons, an indication of the priority of different criteria within sector/industry	
	• Weighting of E, S and G pillars against overall ESG rating	
	• Frequency of updating adopted weightings	
	• Indication of alignment of methodology to non-financial reporting standard	

Contents

Field	Information	Possible information format[28]
Processes		
Use of approximations, estimates and assumptions	• Identify where data points are approximations, estimates, proxies and assumptions • Weighting of approximations, estimates and assumptions	Tag and percentage breakdown
	• Indication if a data gap is given a negative or neutral score in the rating • Calculation methods for estimates	Tag/Brief explanation
	• Explanation for selection of industry benchmarks • Further explanation where such a benchmark might not be easily comparable (comparing entities from different geographical regions or using a benchmark based on an industry dominated by state-owned entities with a privately-owned entity)	Brief explanation

Contents

Field	Information	Possible information format[28]
Processes		
Use of industry averages	• Identify where industry averages are used in rating, with geographic split of industry averages used	Tag
	• Rationale for use of industry average	Brief explanation
Controversies	• Badge stating whether rating includes or excludes controversies	Tag
	• Flag when rating is changed due to controversies • Impact of controversies on the rating	Date of addition of controversy and impact on rating
	• Explanation of controversy methodology (i.e. how significant a controversy must be before it impacts the rating, whether controversy measurement is industry-specific)	Brief explanation
	• Outline the conditions required for a lifting or upgrading the controversy badge	Brief explanation
	• Indication of the time period to which the controversy relates • Where this time period is more than one year old, explanation of why the controversy remains relevant to the rating, an estimation of how long the controversy may remain relevant, and what research/engagement has been undertaken since to review	Tag/Brief explanation

Contents

Field	Information	Possible information format[28]
Processes		
Scope of assessment	**Group entities:** ● Providers should make clear which related entities and which aspects of an entity's business are caught within the rating o Indication of whether holding company's rating includes data from subsidiaries o Indication of the threshold for determining whether this subsidiary is considered in the holding company's rating	Brief explanation
	Policies: ● Indication of weighting attributed to existence and implementation of relevant ESG policies of the company	Percentage breakdown Indicative list of policies by industry
	Reports: ● List of reports and other disclosure reviewed	List
	Current vs future actions: ● Indication of weighting attributed to current vs future actions by rated entity (e.g. commitments to future projects)	Brief Explanation
	Risks considered in assessment: ● Indication of weighting attributed to manageable vs unmanageable risk	Percentage breakdown
	Size bias: ● Indication whether 'size bias' (potential bias based on capital or size of the rated company) has been considered and addressed in the rating assessment and explanation on how this has been done	Brief explanation

Contents

Field	Information	Possible information format[28]
Processes		
Use of expert/ analyst judgment (where applicable, noting not all ESG ratings involve use of substantial rating-specific analytical input from a rating analyst)	• Indication of weighting attributed to expert judgment/analyst input • Outline of which indicators or data points required significant expert judgment/ analyst input • Indication of average level of experience of experts/analysts	Brief explanation
	• Indication of any data points provided by the rated company that have been 'overridden' or amended by experts/analysts and brief explanation of the reason for this intervention • Indication of whether this has been communicated to the rated company	Brief explanation
Time horizon	**Date of rating:** • Label original date of rating, when the rating was last reviewed and the next review • Label stating frequency and type of review (including what type of update will occur and when)	Tag
	Use of forward-looking modelling: • Explanation of how the methodology uses forward-looking modelling (how it addresses forward looking assessments and assumptions, and emerging risks)	Brief explanation

Contents

Field	Information	Possible information format[28]
Processes		
Geographical horizon	• Indication of how the location of rated company's HQ and location of other group entities is addressed in the rating • Indication of how relevant locations are determined (e.g. on revenue basis, geographical basis)	Brief explanation Quantitative granularity on how operations in different countries affect the score
Unsolicited ratings (applicable where the rated company is either unaware it is being rated or is not involved in providing information to the ESG rating provider)	• Tag to indicate whether rating is solicited or unsolicited (or whether both types of ratings exist for the same entity) and whether there was issuer engagement	Tag
	• Notification to companies to alert them that they are being rated or when there are changes to their rating	Notification
	• Indication of whether, and if so, how many, ratings are outstanding for one company	Brief explanation
Governance	• Identify analyst and/or committee responsible for publication of issuer rating	Tag
	• Outline conflicts of interest policy	Brief explanation

Contents

Field	Information	Possible information format[28]
Post-assessment rating		
Key reasons for sub-ratings and overall rating	● Explanation of key reasons for each of the E, S and G pillar ratings being scored high, medium or low	Brief explanation
	● Indicate where the same data is used multiple times for different scores/fields	Tag
	● Explanation of key reasons for overall ESG rating being scored high, medium or low	Brief explanation
Engagement – updates, upgrades and/or corrections	**Engagement by rating providers with rated entities:** ● Indication of whether the rating provider has engaged with the rated entity following assessment process before publication of the rating to the market **Opportunity to provide further information or correct errors:** ● Indication of whether rated entity has been provided an opportunity to provide further information on data points to upgrade their rating or correct any inaccuracies in the underlying data points, and relevant time periods given to respond	Brief explanation
	Timeliness of updates to ratings: ● Indication of how frequently rating providers undertake reviews of underlying data to make relevant updates to the rating ● Indication if a full ratings report is updated or only specific sections	Tag

Field	Information	Possible information format[28]
Post-assessment rating		
Escalation/ complaints processes	• Outline the formal escalation processes for rated entities to request the rectification of errors in ratings by rating providers in timely manner	Brief explanation
	• Indication of whether a rated company will need to pay or obtain a solicited rating to rectify error	
	• Indication of the intervals at which a rated company can report data inaccuracies and an explanation of who determines these intervals (e.g. whether there is industry input or it is determined by the rating provider's resources)	
Changes to methodology	• Notification to the market of material changes to methodology and explanation of how materiality is determined • Indication of whether the market was consulted (e.g. through RFCs) and whether the impact of changes on the wider industry has been assessed	Notification/Brief explanation

Contents

Final remarks

ESG ratings remain an evolving product type. The methodologies of ESG rating providers and the transparency that they provide, have, and will continue to develop, as will the disclosure regimes for issuers which should improve the quality of the underlying data upon which they rely. As this area of the market further matures, a natural evolution might be an industry-led effort to refine the 'proposals for ESG rating providers' into a more focused list of disclosure requirements, creating a degree of convergence on the most important disclosures which should be provided by all rating providers, while keeping in mind the requirements for proportionality and phase-in noted in the previous section. This could set a benchmark level of transparency across the industry as ESG ratings become a fully-embedded part of the capital markets landscape.

Contents

End notes

1. IRSG, ESG Ratings and ESG Data in Financial Services, p 26.
2. IOSCO Final Report on ESG Ratings and Data Products, p 27.
3. It is noted, however, that independence of ESG ratings is important, as with more "traditional" research.
4. Solicited ratings being where a rating is assigned pursuant to a direct request by an issuer.
5. IOSCO Final Report on ESG Ratings and Data Products, Recommendation 5; European Commission Study on Sustainability-Related Ratings, p 13.
6. IOSCO Consultation Report on ESG Ratings and Data Products, p 25; IRSG Accenture Report on ESG Ratings and ESG Data in Financial Services, p 12 and 28; OECD Business and Finance Outlook 2020: Sustainable and Resilient Finance, section 1.3.2.
7. European Commission, Guidelines on reporting climate-related information, p 6.
8. European Commission, Guidelines on reporting climate-related information, p 7.
9. ESG: Why the Ratings Diverge, CAIA.
10. See AFME's response to ESMA's Call for Evidence.
11. Note that controversies may be included as part of an ESG rating report or sold separately (see European Commission's Study on sustainability-related ratings, data and research, p 61).
12. Financial Times, ESG controversies wipe $500bn off value of US companies, (Chris Flood, December 2019).
13. IFRS, International Sustainability Standards Board.
14. IFRS, General Sustainability-related Disclosures.
15. EFRAG, Sustainability reporting standards roadmap.
16. ESMA Sustainable Finance Roadmap 2022-2024, p 7 and 13.
17. IOSCO Final Report on ESG Ratings and Data Products, Annex 1: Glossary, p 44.
18. See European Commission's Study on sustainability-related ratings, data and research, November 2020.
19. Based on the process outlined by the European Commission's Study on sustainability-related ratings, data and research, November 2020.
20. Aggregate Confusion: The Divergence of ESG Ratings, (Florian Berg, Julian F Kölbel, Roberto Rigobon), August 2019, p 3.
21. Aggregate Confusion: The Divergence of ESG Ratings, (Florian Berg, Julian F Kölbel, Roberto Rigobon), August 2019, p 3.
22. Drawing on the European Commission's Study on sustainability-related ratings, data and research, November 2020.
23. European Commission's Study on sustainability-related ratings, data and research, November 2020, p 163.
24. IOSCO Final Report on ESG Ratings and Data Products, p 30.
25. European Commission's Study on Sustainability-Related Ratings, Data and Research, November 2020, p 163.
26. IOSCO Final Report on ESG Ratings and Data Products, p 30.
27. IOSCO Final Report on ESG Ratings and Data Products, p 42.
28. Where a percentage breakdown is recommended, ratings providers are encouraged to consider displaying this information graphically (such as in a pie chart or other diagram) for ease of user understanding.