Study on Sustainability-Related Ratings, Data and Research

Executive summary

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The Directorate‑General for Financial Stability, Financial Services and Capital Markets Union

Abstract

Europe leads the way globally on sustainable investing. In 2018, the total assets committed to sustainable and responsible investment strategies exceeded €12 trillion, representing 46% of the global total. The growth in global assets committed to sustainable strategies is forecast to continue over the next decade, as sustainable investing becomes fully integrated into asset management. A key requirement of forming sustainable investment strategies is access to high-quality sustainability-related data, ratings and research. In this context, this study describes the state of the play of the sustainability-related products and services market; establishes an inventory and classification of market actors, sustainability products and services available in the market; and analyses the use and quality of sustainability-related products and services by market participants. The study explores how the reliability and quality of assessment of sustainability-related data, ratings and research by third party providers can be enhanced and provides recommendations to stimulate demand and improve the quality of supply. This research is based on a combination of desk research and stakeholder engagement with various actors across the value chain. For the latter, stakeholders ranging from listed companies, to sustainability-related data, ratings and research provider, asset management and owners, industry experts and non-governmental organisations participated either through an online survey or in depth interviews.

Executive Summary

Background and Development

The rapid growth in global assets committed to sustainable and responsible investment strategies experienced over the last decade is forecast to continue as sustainable investing becomes fully integrated into asset management. A key requirement of forming sustainable investment strategies is access to high-quality sustainability-related data, ratings and research. The corresponding growth in demand for sustainability-related products and services has led to an increasing number of players entering the market and an uptick in merger and acquisition activity as traditional financial services and research firms seek to expand their service offerings by buying up specialized sustainability-related product and service providers.

In Europe, sustainable investing has been practiced for at least two decades and the market is relatively mature in comparison to other regions. To date, the European Union has been the most ambitious regulatory authority on sustainable finance. The European Commission developed a comprehensive policy agenda on sustainable finance in 2018, comprising the action plan on financing sustainable growth and the development of a renewed sustainable finance strategy in the framework of the European Green Deal. It has established numerous regulations including the Non-Financial Reporting Directive (NFRD) and the EU Taxonomy Regulation among others.

At present, sustainability-related products and services are not regulated by public authorities, though a few specific regulations may apply to specific types of products. Self-regulatory initiatives and market standards have proliferated in recent years including responsible business conduct initiatives (e.g. UN Global Compact, UN Sustainable Development Goals), corporate disclosure initiatives (e.g. CDP, Sustainability Accounting Standards Board, Task Force on Climate-related Financial Disclosures) and responsible investing initiatives (e.g. the UN Principles for Responsible Investing).

Increasingly providers are offering an array of sustainability-related products and services including raw data, ratings and rankings, screening services, indices and benchmarks, and climate-specific products. With the exception of ISS which was acquired by Deutsche Börse AG in November 2020, the major providers are all currently headquartered in North America or the United Kingdom. This includes leading providers MSCI, S&P, Moody's, Fitch's, and CDP. All these have operations in the EU, due in part to the acquisitions of previously well-established EU headquartered providers such as Sustainalytics, Vigeo Eiris, Oekom and SAM. The leading providers all sell products to EU-headquartered investors and include EU companies in their coverage. There are also an estimated 30 to 40 other smaller providers of sustainability-related rating, data and research products and services domiciled in the EU.

Current Approach

The flow of information in market generally comes from companies through sustainability-related product and service providers to investors. Defining characteristics about this flow of information through various actors shape the market, and lead to specific pain points. The three areas of focus in this report are:

1. The flow of information about companies to sustainability-related product and service providers.
2. How sustainability-related product and service providers evaluate, package and sell that information.

3. How that information is used by customers (e.g. investors, benchmark administrators).

The Flow of Information on Companies to Sustainability-Related Product and Service Providers

Data sources utilized by providers across all of their sustainability-related products and services fall into three major categories: Data directly from the company covered, unstructured company data from alternative sources, and third-party data that has already flowed through a different provider. Though the primary source of information identified by most providers is self-disclosed company data, providers commonly utilize data from all three sources with distinctions depending on the methodology, approach and product or service offered.

Where providers are not able to get direct data, they will often estimate data. Across our findings the bulk of data estimation occurs in specific issue areas, such as carbon emissions, and in estimates of revenue that are affected by a particular sustainability-related issue.

Providers have various multi-step approaches to assuring the quality of the datasets they use, both in terms of errors, and timeliness of data updates, but companies and investors alike have expressed frustrations at lower data quality, and inaccurate information. Although several product and service providers engage directly with companies to gather primary data and information, to facilitate data verification, and to allow for error correction and grievance resolution, companies want to see more direct communications, greater engagement more meaningful dialogue with providers.

For companies, addressing multiple individual requests for data and information on sustainability-related performance from stakeholders can be time intensive and costly. There are a variety of stakeholders that request such information, including, but not necessarily limited to, business-to-business clients or customers, regulators, non-governmental organisations, industry associations, the media, local communities, research bodies, shareholders, investors and sustainability-related ratings, data, ranking and benchmarking providers. Investor and sustainability rating, data and research providers form only part of this demand. Based on the survey conducted for this report, companies spend an average of 316 days per year completing their own company sustainability reports and other disclosures, and an average of 155 days per year responding to and managing sustainability-related ratings and ranking providers. This would equate to approximately one full time employee equivalent for sustainability reporting and disclosures and half a full time employee equivalent to respond to requests from sustainability-related rating, data and research providers. Companies also report that certain rating questionnaires such as CDP or the SAM CSA can take upwards of 300 hours or approximately 40 person days to complete each.

How Sustainability-Related Product and Service Providers Evaluate, Package and Market Information (through the Lens of Ratings Products)

When looking at the development of ratings products, provider methodologies follow three broad steps: 1) determining which indicators of sustainability exposure or performance are most material to the sector in question, 2) gathering and assessment of data, and 3) scoring and weighting the data points and calculation of the rating. Providers typically update those company ratings on an annual basis, although some are starting to update more frequently as new technology makes those processes more efficient, and more frequent updates can provide a competitive distinction. The majority of providers are also undertaking methodology reviews on an annual basis.

Sustainability-related rating providers measure, weight and score company sustainability risk and performance in different ways. This results in comparability issues of ratings across providers for the same target company even with similar starting data points.

There are also three key types of bias typically encountered by sustainability-related ratings providers. The first, and most commonly referenced, is company size bias, where larger companies may obtain higher sustainability-related ratings because of the ability to dedicate more resources to non-financial disclosures. Second is geographical bias, where there is a geographical bias toward companies in regions with high reporting requirements. Third is industry bias, where sustainability-related ratings providers oversimplify industry weighting and company alignment.

This bias and the variation that occurs across methodologies contribute to weak correlation or divergence across scores from different companies.

How Sustainability-Related Products and Services Are Used by Customers

Almost all asset managers now receive some of their sustainable investment information via sustainability-related rating, data and research providers. The use of sustainability-related data has moved beyond solely the large asset managers, who have the resources to subscribe to multiple providers, to a wider audience through the use of data aggregators such as Bloomberg, which give access to multiple sources of sustainability-related ratings and data, in addition to and detailed sustainability-related metrics to all asset managers that subscribe to the Bloomberg Terminal service.

Benchmark administrators are divided between those that use in-house teams to gather data and produce the ratings that underpin benchmarks (e.g. FTSE, MSCI) and those that outsource such collection to third parties (e.g. Solactive outsources to ISS; Stoxx outsources to Sustainalytics). Importantly, the nature and extent of research required depends on the type of products that the benchmark administrator seeks to offer in respect of ESG.

Asset owners' activities in sustainable investment tend to focus on asset allocation, manager selection and monitoring, reporting & communications, and industry & public policy activity. Some asset owners have in-house investment capacity while others outsource entirely to external asset managers. As a result, their use of sustainability-related ratings, data and research differs significantly. In general, they tend to need portfolio-wide analytics rather than single stock data, research or ratings.

The Views of Stakeholders

Asset managers and asset owners report that the collection and aggregation of data is a valued service, largely due to lack of internal capacity to conduct such research. They also report that companies do not publish sufficient or comparable data and that sustainability-related rating, data and research providers do not always cover material issues, focus more on providing ratings rather than data (which is of greater value to them), and are backwards looking in their analysis.

When asked how sustainability-related products and services could better meet their needs, asset managers, asset owners and benchmark administrators responded with some clear themes. They would like greater transparency, more focus on sector-specific material issues; a focus on product impacts and actual performance, and less on company policies and disclosures; more raw data, better data quality and greater consistency rather than singular ratings; stronger links to financial materiality and a better insight into associated financial risks for companies.

Companies identified several areas effectively assessed by sustainability-related products and services: numerical or measurable data points; environmental topics; areas where there is good company engagement between provider and the company being assessed; and reporting. Areas less accurately represented by sustainability-related products and services include those that require a higher degree of qualitative interpretation such as governance policy, processes, investment; and some social issues, including stakeholder engagement, human rights, labour practices, community and training and development.

The frustrations reported by companies are that sustainability-related rating, data and research providers do not gather and process data and information in a timely, reliable or efficient manner; that providers' methodologies are opaque and do not sufficiently take into account company context; that providers make errors (and are slow to correct them) and that engagement with multiple providers is time-consuming. The majority of reporting companies believe sustainability exposures and practices are only moderately reflected by sustainability-related rating, data and research providers, and overall are frustrated by a lack of transparency and comparability across providers. In addition, they state that most asset managers do not ask sustainability oriented questions during their regular meetings with company management.

Sustainability-related rating, data and research providers report that companies do not publish sufficient reliable data to enable appropriate comparability and analysis, while at the same time asset managers demand increased breadth, depth, and quality of data.

All stakeholders commented that the market for sustainability related ratings, data and research is growing whilst at the same time there is consolidation as larger, US-headquartered financial services companies have acquired the leading specialist sustainability-related rating, data and research providers; that there are some inherent conflicts of interest with the provision of sustainability-related products and services; and that there is a need for greater transparency across the industry in terms of methodology and disclosure as to how sustainability-related ratings, data and research providers assess performance.

Conclusions and Recommendations

There are several key issues identified that are considered to be obstacles to the further development of the market.

There is an **overall demand for greater transparency** of objectives sought, methodologies adopted and quality assurance processes in place by sustainability-related rating and data providers. For example, few providers disclose the underlying data sets, indicators or weightings applied. Sustainability-related ratings are the views of the provider undertaking the evaluation, against criteria they determine. Without full transparency of the methodology adopted, it is not possible to assess how effective they have been in evaluating a company, or whether the criteria selected align with the sustainability objectives of the user. A lack of transparency leads to the a lack of understanding as to what the rating represents and presents a risk that investors will take sustainability-related ratings at face value, without making their own judgements and considering whether and how well a rating helps the investor meet their sustainability investment objectives.

The **timeliness, accuracy and reliability** of the output from sustainability-related rating and data providers was a concern raised by companies and asset managers. Investors are demanding more data granularity and have high expectation on data quality, consistency and timeliness, so they can better integrate this into their own financial analysis.

This existance of **bias and low correlation** across sustainability-related ratings are broadly recognized across all market participants. The consequences of divergence, or low correlation, vary from bringing into question the credibility of sustainability-related ratings, to being an impediment to prudent decision-making aimed at moving capital to more sustainable investments – this being particularly the case when investors lack an appreciation of the limitations of sustainability-related rating and data products.

The potential for **conflicts of interest**, particularly associated with providers both evaluating companies and offering paid advisory services, was highlighted. Providers selling multiple products require an elevated and appropriate separation between departments to avoid potential conflicts of interest.

There is a need for a focus on **materiality** given the extensive breadth of topics covered, and resulting hundreds, if not thousands, of indicators used. The breadth and complexity of the data creates a large amount of 'noise' in assessments by sustainability-related rating and data providers, which can have the effect of overwhelming the signal resulting in truly material issues being lost amongst the detail. Companies and asset managers alike noted a lack of sufficient **contextual understanding** of the industry covered by some sustainability-related rating and data analysts.

Company sustainability disclosures are considered to lack comparability, consistency and completeness, despite the growth in uptake of the numerous sustainability reporting standards that exist. The need for standardised reporting by companies so that investors and sustainability-related product and service providers can better assess performance is acknowledged across market participants.

A source of frustration is the overall lack of **engagement with and by companies** on sustainability-related issues, both in terms of insufficient meaningful direct communication with investors on these issues, and the lack of dialogue (and the inability to correct errors) with sustainability-related rating and data providers. It was also noted that companies, and other market participants, perceive that they receive 'hundreds of questionnaires on sustainability and ESG from investors'. However, very few sustainability-related rating, data and research providers that have any material influence on the investment value chain rely on issuing questionnaires.

There is a lack of **clear and consistent terminology** used and a need for clearer and standardized definitions for sustainability-related products and services. This includes key terms such as ESG, sustainability and responsible investment. There is no consensus on a set of standards and principles for sustainability-related products and services, or how to measure and verify the implementation of them.

Recommendation	Issues addressed
1. The **disclosure of sustainability-related rating methodologies**, including key factors such as the specific assessment criteria, sources of data, rationale for weighting, and any standards or guidelines considered.	• Transparency
2. The development and application of **industry standards for sustainability-related rating and data products providers**, including the establishment of a certification system and the appointment of an appropriate supervisory body. The industry standards would cover sustainability-related rating and data providers, and include elements such as the overall objectives of the rating and data provider, appropriate governance structures and codes of conduct, means of engagement with companies, the process for correcting errors and updating assessments, the transparency of methodologies, the consideration of materiality and risk of bias.	• Transparency • Timeliness, Accuracy and Reliability • Bias and Correlation • Conflicts of Interest • Materiality and Contextual Understanding • Engagement with and by Companies • Clear and Consistent

	Terminology
3. The **communication of sustainability-related ratings, data and research with target companies**, including requiring that this is shared free of charge and restricting communication of outputs ahead of publication.	• Bias and Correlation • Conflicts of Interest • Engagement with and by Companies
4. Require sustainability-related rating, data and research providers to issue a **purpose and limitation statement for published sustainability-related rating, data and research** to users, order to provide clarity on the objectives of the product and any limitations that are considered to apply.	• Transparency • Bias and Correlation • Materiality and Contextual Understanding • Clear and Consistent Terminology
5. Seek to ensure **public disclosure of the management of conflicts of interest by sustainability-related rating data and research providers**. Sustainability-related product and service providers should be required to publically disclose their policies and procedures for the prevention and management of potential conflicts of interest, or explain why they do not have such a process in place.	• Conflicts of Interest
6. Require disclosure in the form **sustainability-related declarations by asset managers** in relation to the application of sustainability factors in investment management practices, the integration of sustainability factors into the investment analysis of companies they own, a report on sustainability engagement action undertaken and the percentages of research spend on sustainability investment research. It is noted that this recommendation should be reviewed in light of the publication of the SFDR technical standards.	• Transparency
7. Take action to **enhance company sustainability disclosures** with the aim of improving the comparability, completeness, consistency and quality of data disclose. It is recognized that the Commission is already addressing this issue through the revision of the NFRD planned for 2021.	• Company Sustainability Disclosures
8. Provide **clarity of terminology and support capacity building on sustainable finance and sustainability-related products and services for all market participants and stakeholders** to address the need for greater consistency in key terms used and definitions applied, and improved awareness of sustainability-related products and services across market actors.	• Clear and Consistency Terminology

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