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FIA EPTA response to the ESMA Call for Evidence On Market Characteristics for ESG Rating Providers in the EU

Introduction:

The FIA European Principal Traders Association (FIA EPTA) welcomes the opportunity to respond to the European Securities and Markets Authority (ESMA) Call for Evidence On Market Characteristics for ESG Rating Providers in the EU.

FIA EPTA represents 26 independent European Principal Trading Firms (PTFs) which deal on own account, using their own money for their own risk, to provide liquidity and immediate risk transfer in exchange-traded and centrally-cleared markets for a wide range of financial instruments, including shares, options, futures, bonds and ETFs. FIA EPTA's members are based in the Czech Republic, Germany, Ireland, The Netherlands, and the UK.

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

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

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

6.2 Questionnaire B for Users of ESG Rating Providers

6.2.4 General views on ESG ratings in EU Financial Markets

Question 1. Please provide your views on the level of relevance of ESG ratings to EU financial markets and financial market participants. Do you consider this level will increase in the coming years?

FIA EPTA members believe ESG ratings are extremely relevant for EU financial markets and financial market participants. Most financial market participants base their investment decisions based on internal reviews in combination with available data from data/rating providers. The data from these companies need to be transparent and clear about what they entail. FIA EPTA members are pleased that there is a growing number of ESG products available on European trading platforms and that the interest in these products keeps growing. With the growth of ESG products, the underlying data will only grow in relevance, FIA EPTA members believe that investors need to know how ESG products and indexes are measured by rating agencies. That transparency is needed to continue the growth of the ESG market.

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

FIA EPTA members also believe that ESG ratings should also focus more on climate opportunities and not just on low carbon portfolios as for the change that is needed, the first will play a much more important role as it embodies the change that is needed towards sustainable capital markets and to realise climate goals.

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

As stated above, FIA EPTA members believe that ESG data and ratings are relevant and needed for financial market participants, institutional investors and (professional and personal) end-investors who use ESG ratings and data to make investment decisions. ESG investments will grow and for the trust of financial market participants in these products, more transparency is needed.

Question 2. Please provide your views on the level of risk ESG ratings currently pose to orderly markets, financial stability and investor protection in the EU. Do you consider this level will increase in the coming years.

FIA EPTA members believe that current ESG ratings could pose a risk to orderly markets, financial stability and investor protection in the EU. FIA EPTA members would encourage the EU to continue with its regulatory objectives to get more transparency in the ESG markets as it could become a risk to markets if the growing number of ESG products have unclear ratings. As ESG represents a new order of responsibility the products and indexes should also aim to have a high level of transparency so that the products and indexes are indeed worthy of an ESG label.

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

FIA EPTA members believe that if the meaning of ESG ratings are not clear and transparent, they can become a risk to the orderly markets as trust in products is key, especially with ESG products. However, FIA EPTA members believe that the ESG market is relatively young and with the exceptional interest by public and market stakeholders improvements can be made to secure the success of the sustainability goals for the European capital markets.