

CONSULTATION RESPONSE

ESMA CONSULTATION PAPER ON GUIDELINES ON DISCLOSURE REQUIREMENTS APPLICABLE TO CREDIT RATINGS

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INTRODUCTION

ABOUT THE PRI

The United Nations-supported Principles for Responsible Investment (PRI) is the world's leading initiative on responsible investment. The PRI has over 2200 signatories (pension funds, insurers, investment managers and service providers) globally with approximately US \$83 trillion in assets under management. Of these, over half are based in Europe.

The PRI works with investors, policy makers, regulators and other stakeholders towards a more sustainable financial system. The PRI has experience of responsible investment public policy reform in multiple markets, including the UK, Europe, US and China. The PRI was an observer to the European Commission's [High Level Expert Group on Sustainable Finance](#) and is rapporteur on the taxonomy working group of the [Technical Expert Group on Sustainable Finance](#).

The PRI welcomes the opportunity to comment on ESMA's Consultation Paper on the 'Guidelines on Disclosure Requirements Applicable to Credit Ratings'. These comments focus on the disclosure guidelines relating to ESG factors (Questions 5 and 6). They are drawn from insights from the ESG in Credit Ratings Initiative and emerging practices in relation to the incorporation of ESG factors into credit risk analysis.

ESG IN CREDIT RATINGS INITIATIVE

Since 2016, the PRI has coordinated the [ESG in Credit Ratings Initiative](#), which works to enhance the transparent and systematic integration of ESG factors in credit risk analysis. The initiative launched with a [Statement on ESG in Credit Ratings](#), which now has support from 151 investors¹ with nearly \$30 trillion of assets under management (AUM) and 18 Credit Rating Agencies (CRAs), including the three largest global CRAs.

As part of this initiative, the PRI has been facilitating discussions between more than 420 credit practitioners in 15 countries to cultivate a common language, discuss ESG risks to creditworthiness and bridge apparent investor-CRA disconnects. This investor-CRAs dialogue has highlighted many positive developments, including expanding resources, analytical tools and increasing transparency efforts. However, it has also underlined that ESG consideration in credit risk analysis is still not addressed consistently by all market players.

¹ The full list of signatories to the statement is available [here](#).

RESPONSE TO DETAILED QUESTIONS

4. ENVIRONMENTAL, SOCIAL AND GOVERNANCE FACTORS UNDER THE CRA REGULATION

Text of proposed guidelines

With regard to the disclosure as to whether and how ESG factors were considered as key underlying elements of a credit rating issuance in accordance with Article 10(1), 10(2) and Section D, Annex I, I, points 2a and 5, CRAs should:

- i. Include a direct web-link at the bottom of each credit rating press release to the section of that CRA's website that includes guidance explaining how ESG factors are considered as part of that CRA's credit ratings. [Annex I Section D, I, 2a]
- ii. Outline in the press release whether any of the key underlying elements of the credit rating issuance correspond to that CRA's categorisation of ESG factors. [Annex I, Section D, I, 5]
 1. Where ESG factors were not a key underlying element of the credit rating, the CRA should include a statement in this regard.
 2. Where ESG factors were a key underlying element of a credit rating, the CRA should clearly identified whether the factor or factors refers to either an Environmental, Social or Governance factors. [Annex I, Section D, I, 5]

Question to stakeholders

Q5: Do you have any comments on the proposed Guidelines under this section?

The Guidelines represent a significant step forward towards transparency, by encouraging better signposting of how ESG factors may contribute to a credit rating opinion, rating outlook or related action. The PRI recommends the following points be taken into account:

(1) Point i:

The methodology for a credit rating opinion should consider ESG factors, because they may materially affect the credit quality of the rated entity. The CRA Regulation already requires that when a CRA issues a credit rating it discloses the principal methodology(s) used in determining the rating, including a link to them on the CRA's website (as observed on page 12 paragraph 35 of the consultation paper).

The new guidelines should include that CRAs need to clarify:

- a) how ESG factors are taken into account in their principal methodology;
- b) display this information via their website;
- c) provide a direct-link to the document (s) where it is explained how ESG factors feature in their methodology in the press release accompanying credit rating opinions, rating outlooks or rating action (this could be anywhere in the press release, not necessarily at the bottom, as long as it is clearly signposted and easy for the user of the ratings to find).

(2) Point ii

The PRI recommends the guidelines be amended as follows:

- ii. *Outline in the press release whether any of the key underlying elements of the credit rating **and/or rating action** (issuance **or change in rating opinions or rating outlooks**) correspond to that CRA's categorisation of ESG factors. [Annex I, Section D, I, 5]*
1. *Where ESG factors were not one of the **material elements** of the rating opinion **and/or rating action**, the CRA should include a statement in this regard. **CRAs are not required to disclose a list of all ESG factors considered.***
 2. *Where ESG factors were one of the **material elements** of a rating **and/or the rating action**, the CRA should clearly identified whether the factor or factors refers to either an Environmental, Social or Governance factors. [Annex I, Section D, I, 5]*

This recommendation is based on the following analysis:

- The expected statement should explain how the ESG factors have contributed to the improvement or the deterioration of the credit quality of the entity or instrument rated (i.e. the financial implications of ESG factors on the cashflow and balance sheet of the rated entity). One of the most frequent comments shared during the investor-CRA dialogue that the PRI has nurtured on ESG risks was that there is a lot of confusion between how ESG factors affect credit ratings and ESG assessments compiled by ESG-specialised service providers. Therefore, it should be clear that the disclosure around ESG factors should not be on how these impact a rated entity's business model but its credit quality.
- The PRI recommends to substitute the words 'key underlying' with 'material' to avoid the impression that ESG factors are different from other relevant credit material factors that can contribute to forming a rating opinion or its related action.
- ESG factors can be one of many material (financial and non-financial) elements considered to form a credit rating opinion. The PRI notes that singling out ESG factors among a range of other factors is only relevant if the disclosure requirements explicitly stress the financial materiality of the factors.
- The disclosure requirements should apply to ratings opinions, rating outlooks and rating action (i.e. changes in rating opinion and/or rating outlooks). ESG factors are dynamic and rapidly evolving and their impact on rating action is as relevant as their influence on ratings' affirmation.
- Where ESG factors were not a key underlying element of the credit rating, we note that the draft guidelines could be read to imply that all non-relevant factors should be stated. While we do not believe this is ESMA's intent and clarification on this point would be welcome. However, the PRI recommends that ESMA's guidelines encourage users of the ratings to engage with the persons primarily responsible for approving the credit rating or rating outlook (indicated in the press release as per Annex I, Section D, I,1) to better

understand why certain ESG factors that may be considered material by the users of the ratings were not deemed material by the CRA, thus nurturing a dialogue to better understand ESG risks to creditworthiness, a dialogue that the PRI has started to promote.

Finally, the PRI recommends that ESMA discusses with CRAs an indicative conceptual framework to support CRAs in categorising ESG risks. The guidelines have been drafted based on an understanding that CRAs have varying categorisation of ESG factors (e.g.p. 20, paragraph 66). The framing of Guideline ii, referring to “CRA’s [own] categorisation of ESG factors”, could lead to inconsistent disclosures by CRAs and goes against the idea of minimum standards in terms of quality of information in the rating issuance or its related action. Whilst acknowledging that CRAs must be allowed to maintain full independence in determining which criteria may be material to their ratings, the PRI recommends that ESMA discusses with CRAs an indicative conceptual framework to support CRAs in categorising ESG risks. The ESG in Credit Ratings Initiative has established a [conceptual framework for investors](#) based on roundtable discussions. This analysis could be used to inform discussions on a similar framework for CRAs.

Regarding ESMA’s analysis in paragraph 66, our interpretation is that the taxonomy be considered a policy tool to drive capital towards sustainable outcomes rather than a conceptual framework for categorisation of ESG outcomes. The taxonomy will be a critical tool for investors and issuers. However, if implemented as per the draft regulation, the taxonomy will seek to identify activities which make a substantive contribution to environmental objectives. It will not make judgement on the credit quality of an investment.

Q6: Are there any additional actions that CRAs could take to improve the disclosure of the consideration of ESG factors?

To further support ESMA’s analysis of the overarching regulation the **PRI recommends that the ESMA guidance:**

- Specify, when environmental factors have been one of the key elements of the rating action, the underlying assumptions of that assessment. For instance, if a climate factor has been assessed as material, specify the climate scenario or trajectory used for the analysis.
- Provide links to analyses (thematic research, sector research, stress testing, sensitivity analysis, or scenario analysis) that can help understand if an ESG factor might become one of the key material elements of the credit rating or credit opinion in the future and needs monitoring.

This is consistent with Annex I, Section D, I, 2 of the CRAs regulation, which requires CRAs to give appropriate risk warning, including sensitivity analysis, of relevant rating assumptions.