PRI RESPONSE

ESMA CONSULTATION ON POSSIBLE AMENDMENTS TO THE CREDIT RATING AGENCIES REGULATORY FRAMEWORK

21 June 2024

To inform this briefing, the following investor groups have been consulted: PRI Global Policy Reference Group, Credit Risk and Ratings Advisory Committee and Sovereign Debt Advisory Committee. This consultation is not an endorsement or acknowledgement of the views expressed in this briefing. It is important to note that some credit rating agencies might disagree with the PRI position.

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ABOUT THE PRI

The Principles for Responsible Investment (PRI) works with its international network of signatories to put the six Principles for Responsible Investment into practice. Its goals are to understand the investment implications of environmental, social and governance (ESG) issues and to support signatories in integrating these issues into investment and ownership decisions. The PRI acts in the long-term interests of its signatories, of the financial markets and economies in which they operate and ultimately of the environment and society as a whole.

The six Principles for Responsible Investment are a voluntary and aspirational set of investment principles that offer a range of possible actions for incorporating ESG issues into investment practice. The Principles were developed by investors, for investors. In implementing them, signatories contribute to developing a more sustainable global financial system.

The PRI develops policy analysis and recommendations based on signatory views and evidence-based policy research. We therefore welcome the opportunity to respond to ESMA's call for feedback on possible amendments to the Credit Rating Agencies (CRA) Regulatory Framework.

ABOUT THIS CONSULTATION

The European Commission requested technical advice on potential amendments to the EU's credit rating regulatory framework from ESMA in June 2023. The request focused on how updates could be made to Annex I of the CRA Regulation and Commission Delegated Regulation (EU) Nº 447/2012 (the Delegated Regulation on Methodologies) in order to ensure better incorporation of ESG factors into the credit rating process.

The consultation paper outlines ESMA's proposed amendments to Annex I of the CRA Regulation and the Delegated Act. These include making explicit reference to identifying ESG factors within credit rating methodologies.

The policy recommendations in this document were developed based on signatory engagement, previous consultation responses, and the PRI's own evidence-based research. More specifically:

- PRI Statement on ESG in Credit Risk and Ratings
- CRA examples: How ESG factors are becoming more explicit in CRA commentaries
- PRI consultation response on the regulation of ESG data providers

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KEY RECOMMENDATIONS

The PRI welcomes ESMA's efforts to standardise practices of how ESG factors are incorporated into credit ratings. The proposed amendments would address the needs of investors and other users of credit ratings for meaningful and comparable information on inherent ESG risks and opportunities. They would also ensure that investors have all the necessary information to properly evaluate creditworthiness.

The PRI's key recommendations are:

- Clarify that all material risk factors, including E, S and G factors, may influence credit ratings and rating outlooks. This would support the requirement under Article 8(2) of the CRA Regulation that credit rating agencies "*shall adopt, implement and enforce adequate measures to ensure that the credit ratings [they issue] are based on a thorough analysis of all the information that is available*"[1].
- The guidance on incorporating ESG factors into credit rating methodologies from ESMA's Guidelines on Disclosure Requirements Applicable to Credit Ratings[2] should be incorporated into the revised regulatory framework. This would raise standards for the integration of ESG factors into credit ratings while minimising implementation time for CRAs already following the Guidelines.
- ESMA should require ESG factors used in credit rating methodologies to be proactively and publicly disclosed, where these factors are relevant. This supports transparency and stakeholder awareness better than requiring ESG factors to be privately disclosed on request.

[1] Regulation (EC) No 1060/2009 on credit rating agencies – Article 8

[2] ESMA – Guidelines on Disclosure Requirements Applicable to Credit Ratings (2021)

DETAILED RESPONSE

SECTION 1: QUESTION RESPONSES

QUESTION 1: DO YOU AGREE WITH THE ABOVE PROPOSED CHANGES IN ARTICLE 1? IF NOT, PLEASE EXPLAIN.

Yes. The inclusion of reference to rating outlooks ensures alignment with the CRA Regulation as amended in 2013, which views the relevance and effects of rating outlooks as being “comparable to the relevance and effects of credit ratings”[3]. In addition, the proposed changes recognise that ESG factors may influence CRAs’ decisions on rating outlooks. Our review of how ESG factors have become more explicit in CRA assessments found that ESG factors such as exposure to environmental disasters have led CRAs to downgrade credit outlooks, while positive changes such as the implementation of social safeguards by gambling firms have led to improved credit outlooks[4]. It is therefore important to clarify that the proposed amendments apply not only to credit ratings, but also to rating outlooks. This will support the standardisation of disclosures of how ESG factors have influenced CRAs’ rating outlooks.

However, it is also important to note that rating outlooks are qualitative assessments of the likely direction of a credit rating based on trends that have not materialised yet. Therefore, the inclusion of rating outlooks in the Delegated Act could pose some challenges for credit rating agencies. The predictive power of rating outlooks is likely to significantly vary over time and between sectors for a number of reasons. It might then be needed to set a very different, lower, standard than what is required for credit ratings.

In addition, it is positive to clarify the meaning of the term “credit rating methodology” so that it can be standardised across the EU. However, the proposed definition lacks some clarity. Though it refers to “*criteria, models, driving factors and key rating assumptions*”, it does not demonstrate in sufficient detail what kinds of criteria may be used. Further refinement of this definition would clarify that ESG criteria may play a role in credit rating methodologies as defined by the Delegated Act. **We therefore recommend clarifying that the criteria used to assign ratings according to a credit rating methodology include all material risk factors, including governance, environmental and social characteristics.**

QUESTION 2: DO YOU AGREE WITH THE CHANGES PROPOSED IN ARTICLE 3? IF NOT, PLEASE EXPLAIN.

Yes. These changes will ensure consistency and clarity for CRAs. However, further clarity on the types of criteria that may be used should be provided in line with our suggestions in the third paragraph of our response to Question 1.

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[3] Regulation (EU) No 462/2013 amending Regulation (EC) No 1060/2009 on credit rating agencies – Paragraph (7)

[4] PRI – CRA examples (2019)

QUESTION 3: DO YOU AGREE WITH THE CHANGES PROPOSED IN ARTICLE 4(1)(D)? IF NOT, PLEASE EXPLAIN.

Yes. This amendment removes reference to CRAs only needing to incorporate relevant analytical models, key assumptions and criteria into their methodologies “where relevant”. The change correctly suggests that these details will always be relevant. It also ensures consistency between the CRA Regulation and the Delegated Act as amended.

QUESTION 4: DO YOU AGREE WITH THE PROPOSED CHANGES IN ARTICLE 4(2) TO THE DELEGATED REGULATION? IF NOT, PLEASE EXPLAIN.

The Commission’s letter identified two principal issues. First, there is significant variation in how CRAs identify ESG factors and incorporate them into their assessments of creditworthiness. Second, there is insufficient disclosure of how ESG factors have influenced the ratings produced. Our recommendation is a systematic and transparent incorporation of ESG factors in credit risk analysis.

Our 2016 Statement on ESG in credit rating and risk has been signed by 28 CRAs and more than 180 investors (accounting for over US$40 trillion in AUM). It highlights that ESG factors can affect borrowers’ cashflow and likelihood of default, in addition to underlining the importance of allowing CRAs full independence in deciding which factors are material. The signatories supporting this statement have committed to transparently publish their views on the ways ESG factors are incorporated into credit ratings. The proposed amendments support this.

It is positive that CRAs would be required to actively incorporate the requirements to explicitly reference ESG factors into their methodologies, rather than simply having to disclose this information to ESMA on request. Public disclosure of performance on ESG issues provides clear benefits above and beyond what is generated when information is only shared privately. Further, while we recognise it is crucial to disclose how ESG factors have been considered in the analysis process and have affected credit ratings, we note that ‘credit rating agencies must maintain full independence in determining which criteria may be material to their ratings’, as detailed in the PRI Statement on Credit Risk and Ratings’[5].

QUESTION 5: DO YOU AGREE WITH THE ABOVE PROPOSED CHANGES IN ARTICLE 4(3) TO THE DELEGATED REGULATION? IF NOT, PLEASE EXPLAIN.

Yes. The first proposed change to the wording of Article 4(3) is a necessary change to ensure consistency with Article 4(2).

The second proposed change, relating to the information to be disclosed, supports clarity around the importance of each considered factor to the rating assigned. However, we do not agree with the removal of ‘where relevant’, as it would imply that credit rating agencies should provide an explanation for factors that are not credit relevant, and therefore not considered in their analysis. It

[5] PRI – Statement on ESG in credit risk and ratings (2016)

also implies that there is a requirement for set weightings for all quantitative and qualitative factors, which does not allow for the consideration of issuers' particular circumstances.

There is also potential for Article 4(3)(b) to be amended to acknowledge that critical risk factors may also be derived from ESG data such as risk of natural disaster or social controversies. At present, the Article refers only to "*critical risk factors derived from macroeconomic or financial data*". However, as we have identified, CRAs are already incorporating critical risk factors derived from ESG data into their assessments[6]. Regularising this would enhance comparability and helpfulness for all users of credit ratings, in addition to providing reassurance to CRAs that they may consider ESG risk factors as part of their methodologies.

QUESTION 6: DO YOU AGREE WITH THE ABOVE PROPOSED CHANGES IN ARTICLE 5 TO THE DELEGATED REGULATION ON METHODOLOGIES? IF NOT, PLEASE EXPLAIN.

Yes. These are necessary changes to ensure consistency between the CRA Regulation and the Delegated Act, in addition to supporting the effectiveness of the other amendments. However, the use of the phrase "sufficiently detailed" may not provide adequate certainty to CRAs. **It would be useful to provide clarity on what qualifies a methodology as being sufficiently detailed, for instance by satisfying all relevant criteria set out in Article 4(2).**

QUESTION 7: DO YOU AGREE WITH THE ABOVE PROPOSED CHANGES IN ARTICLE 6 TO THE DELEGATED REGULATION ON METHODOLOGIES? IF NOT, PLEASE EXPLAIN.

Yes. In addition to correcting a typo, these amendments expand two points that relate to the impacts of credit methodologies on credit ratings to also include how they impact rating outlooks. They are necessary changes to ensure consistency and the effectiveness of other amendments relating to rating outlooks.

QUESTION 8: DO YOU AGREE WITH PROPOSED CHANGES IN ARTICLE 7 TO THE DELEGATED REGULATION? IF NOT, PLEASE EXPLAIN.

Yes. The changes adding references to rating outlooks are necessary for consistency. The change to clarify that CRAs must ensure that raw data input into credit rating methodologies is properly validated would be positive for the effectiveness of the Delegated Act.

However, there may be added value in emphasising that the validation of a credit rating methodology should also be designed to ensure all material risk factors, including E, S and G factors, are considered in the credit rating methodology. Incorporating a requirement to ensure that no relevant ESG factors have been omitted from a methodology into the validation process would

[6] PRI – CRA examples (2019)

limit the potential for CRAs to fail to consider material ESG factors. This would aid the fulfilment of ESMA's mandate to propose amendments "*in order to ensure a better incorporation of ESG factors in the methodologies and rating process and the further disclosure to the public*"[7].

QUESTION 9: DO YOU AGREE WITH THE PROPOSED ADDITION OF NEW PARAGRAPH 5A IN ANNEX I.D.I TO THE DELEGATED REGULATION? IF NOT, PLEASE EXPLAIN.

Yes. It is positive to incorporate ESG-focused elements of ESMA's Guidelines on Disclosure into the CRA Regulation itself. However, the proposed addition omits point 5.2(6)(iv) of the ESMA Guidelines, the expectation to "*include a link to either the section of that CRA's website that includes guidance explaining how ESG factors are considered as part of that CRA's credit ratings or a document that explains how ESG factors are considered within that CRA's methodologies or associated models*"[8]. **Linking to the methodology is valuable for investors' ease of reference and the proposed amendments may benefit from the addition of the above text to Paragraph 5a.**

QUESTION 10: DO YOU AGREE WITH THE PROPOSED CHANGE IN ANNEX I SECTION A PARAGRAPH 9 OF THE CRA REGULATION? IF NOT, PLEASE EXPLAIN.

Yes. These is a good change to remove ambiguity and clarify that CRAs' review functions must validate methodologies.

QUESTION 11: DO YOU AGREE WITH THE PROPOSED CHANGE TO ANNEX I SECTION D.I PARAGRAPH 2A. OF THE CRA REGULATION? IF NOT, PLEASE EXPLAIN.

Yes. This is a good change to increase transparency so investors can understand the process of validation.

QUESTION 12: DO YOU SEE MERIT IN REQUESTING A DISCLOSURE OF THE USE OF TECHNOLOGICAL INNOVATIONS SUCH AS ARTIFICIAL INTELLIGENCE (AI) IN THE RATING PROCESS?

Yes. We support disclosure of the use of AI in order to maximise transparency and clarity for investors and all other users of credit ratings. This should include information on the stages of the rating

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[7] European Commission – Legislative mandate to develop technical standards (2024)

[8] ESMA – Guidelines on Disclosure Requirements Applicable to Credit Ratings (2021)

process into which AI is incorporated. Disclosure of the use of AI would be valuable for investors so that they can make their own decisions about the reliability of AI-assisted ratings.

SECTION 2: ADDITIONAL RECOMMENDATIONS

SUGGESTED ADDITIONS

The issue of the time horizons (i.e. how to assess ESG risks that may affect credit rating opinions beyond the 'typical' credit rating time horizon) remains an area that needs attention. Credit rating opinions are based on forecasts and the further out these extend into the future, the more uncertain they become. Nevertheless, although many ESG factors are linked to long-term trends, adjusting to these may require changes to business or growth models with credit-quality implications that are near- or medium term (e.g. the costs associated with shifting to electric vehicle production in the automotive industry or to plant-based solutions in the food industry). Hence, further detailing of ESMA guidelines on how CRAs should extend the forward-looking component of their credit opinions would be welcome.

The PRI has experience of contributing to public policy on sustainable finance and responsible investment across multiple markets and stands ready to support the work of ESMA further to ensuring the proper integration of ESG factors into credit rating methodologies in the EU.

Please send any questions or comments to policy@unpri.org.

More information on www.unpri.org