HM Treasury

Future regulatory regime for Environmental, Social, and Governance (ESG) ratings providers

Consultation

Submission by The Financial Inclusion Centre

About The Financial Inclusion Centre

The Financial Inclusion Centre (FIC) is an independent, not-for-profit policy and research group (www.inclusioncentre.org.uk). The Centre's mission is to promote a financial system and financial markets that work for society. The Centre works at two main levels:

Promoting system level change

We research and analyse the environmental, economic, and social utility of finance. We develop policies to promote sustainable, resilient, economically and socially useful financial markets that: benefit the environment; efficiently allocate financial resources to the real economy; and encourage responsible corporate behaviours and create a positive social impact.

Ensuring households' core financial services needs are met

Promoting fair and inclusive, efficient and competitive, well-governed and accountable, effectively regulated financial markets and services that meet households' core financial needs. We do this by undertaking research into the causes of market failure in the sector, formulating policies to address that market failure, developing alternative solutions where the market cannot deliver, and campaigning for market reform. We focus on households who are excluded from, face discrimination in, or are underserved by finance and technology.

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Introduction and background

The Financial Inclusion Centre is pleased to submit a response to this important consultation on the future regulatory regime for Environmental, Social, and Governance (ESG) ratings providers. We very much support the government's intention to give the FCA powers to regulate ESG ratings providers. However, we do have concerns about elements of the government's proposed approach. We also wanted to raise concerns about the FCA's approach to developing an interim voluntary code of conduct on ESG ratings intended to be used until the FCA has the powers to regulate ESG ratings.

As we set out in our report *The Devil is in the policy detail – will financial regulation support a move to a net zero financial system?*[1] the approach to climate finance regulation adopted by policymakers, regulators, and market participants such as ESG ratings providers has hitherto focused on the impact of climate change on the financial system and institutions rather than the impact of finance on the environment (and people). In other words, the focus has been on the *consequences* of climate change, not the *causes*.

This also applies to ESG data, ratings, and ratings providers. According to the FCA, MSCI is the most widely used ratings agency.[2] Yet, its ratings measure the impact of external events on a company's prospects not a company's impact on the environment.[3]

If financial policy and regulation is to be effective in ensuring the financial sector plays its full role in delivering a net zero economy, then this approach would need to change. Financial regulators[4] should increase their focus on assessing the impact of financial institutions behaviours on the environment.

The case for regulation ESG ratings and ratings providers

There is a clear case for regulating ESG ratings and ratings providers. Parallels can be drawn with credit rating agencies who were criticised for the role in the financial crisis of 2008.[5] One of the main criticisms related to the inherent conflicts of interest in the credit ratings system which contributed to the concealing the nature and scale of market risk in the financial system.

Similar conflicts of interest exist in the ESG ratings market. There is a strong incentive for financial institutions to select a ratings provider that produces inflated ESG ratings. The old adage 'follow the money' has particular application in financial markets. As the level of interest and investment in ESG grows, there is a strong incentive for financial institutions to misrepresent the compliance of the firm and its funds/products/ activities with climate goals. This threatens to understate the amount of climate related risk in the financial system.

There is a simultaneous risk of both a proliferation of providers leading to confusion *and* overconcentration in the market. KPMG estimated there were over 150 major ESG data providers worldwide. More recently, the International Regulatory Strategy Group (IRSG) reported there are

[1] The Devil is the policy detail – will financial regulation support a move to a net zero financial system? | The Financial Inclusion Centre
[2] See ESG integration in UK capital markets: Feedback to CP21/18 (fca.org.uk), Fig 3
[3] ESG Ratings: A Compass without Direction (harvard.edu)
[4] FCA, BoE/ PRA, FRC, and TPR
[5] See for example: Credit rating agency reform is incomplete (brookings.edu)

around 30 significant ESG rating and data providers globally. The top three providers accounted for around 60% of the market in 2021.[6]

It is not reasonable to expect end-users of ratings (eg. savers and investors, pension schemes and so on) to identify the best ESG ratings methodology. So, competition (in the form of ratings providers responding to pressure from end-users) will not drive up standards in this market. Rather the competition dynamic is likely to lower standards. Organisations that pay for ESG ratings (whether underlying economic entities or financial institutions) are in a position to select the ratings methodology that portrays their activities in the most favourable light. This would cause ratings inflation and undermine the overall utility of the ratings sector.

So, it is important to regulate the ratings (including methodologies), and ratings providers through the application of robust conduct standards to deal with inherent conflicts of interest and competition dynamics in the market. But, as we explain below, it is also important to regulate the underlying input data used in ratings.

Regulating the building blocks of ESG ratings

ESG ratings can be produced at various levels on: individual real economy entities (whether corporate or sovereign); financial institutions (or parts of a financial business such as loan books); and collective vehicles consisting of portfolios of assets (eg. in the form of investment, pension and insurance funds and products).

Comparative ratings of shares and bonds of individual real economy entities can be undertaken against a relevant peer group (eg. against companies listed on the LSE or within similar industrial sectors). Similarly, financial institutions can be rated against firms in sub sectors of financial services, and collective vehicles can be rated against universes of similar funds or products. In the case of financial institutions and collective vehicles, ratings on the individual assets and an aggregate rating of the portfolio or loan book is required.

The key building blocks of any ratings system (whether rating, ranking, scoring, marking, or benchmarking) are the input data and the models or methodologies used to compare the performance of the economic entity, financial institution, or collective vehicle. It is self-evident that the integrity of a rating system will very much depend on the quality, reliability, and integrity of the foundational input data used in models and the methodologies. If that input data is flawed or misleading then the output ratings will also be flawed or misleading.[7] This increases the risk of greenwashing and misallocation of ESG related financial resources. Unless the underlying data is addressed, we fear that ratings systems will be 'built on sand'.

Serious concerns have been raised about how economic entities account for emissions.[8] So, the new regulatory regime should address the data relating to individual economic entities (which forms the input data), the models and methodologies used to undertake comparisons to produce ratings, and the promotion and use of any ratings. A priority is to ensure real economy entities produce independently verified data on emissions and other environmental factors.

[6] See ESG integration in UK capital markets: Feedback to CP21/18 (fca.org.uk), paras 2.16/17

[7] Garbage in, garbage out (GIGO)

[8] kbs-research-impact-paper-1-emissions-gaming.pdf (kcl.ac.uk)

Meaningful ratings

To have an impact a rating system should be quantitative based not based on qualitative assessment or narrative reporting. A good model is provided by the approach adopted by ESMA to calculate a portfolio greenness ratio for investment funds.[9] As mentioned above, how economic entities account for emissions needs to be addressed as a priority. However, the *approach* adopted by ESMA remains a good one. The portfolio greenness ratio provides an aggregate assessment of a fund which can then be used to compare against peer groups to produce a rating. The Financial Inclusion Centre report on climate related financial regulation contains a model for a trustworthy ratings system.[10]

Much of the detail of how ESG ratings are to be regulated will be worked out later on by the FCA. One of the challenges relates to what to do when verifiable data on portfolio constituents is not available. In this case, this should be disclosed and those constituent assets should not make a positive contribution to calculations involved in a rating – unless verified, eligible proxy data is available.[11]

Interim measures – the Code of Conduct on ESG ratings

In advance of being given powers to regulate ESG ratings, the FCA has announced a working group to develop a voluntary Code of Conduct for Environmental Social and Governance (ESG) data and ratings providers. The group is to be known as the ESG Data and Ratings Code of Conduct Working Group (DRWG).[12] The objectives of the DRWG are to develop (i) a comprehensive, proportionate and globally consistent voluntary Code of Conduct for ESG data and ratings providers, and (ii) a recommendation on ownership of the Code.

We are particularly concerned that the voluntary code working group is dominated by industry representatives.[13] The Terms of Reference of the DRWG[14] state that two industry groups, the International Capital Market Association (ICMA) and the International Regulatory Strategy Group (IRSG), will serve as the Secretariat. This Secretariat will appoint the members of the DRWG.

The DRWG will be co-chaired by M&G, Moody's, the London Stock Exchange Group (LSEG) and Slaughter and May, and composed of stakeholders including investors, ESG data and ratings providers, and rated entities. The FCA envisages that the group will consist of between 15-18 members. Yet only three of the positions are to be reserved for academics and civil society representatives. The FCA, HM Treasury, the Bank of England, the Financial Reporting Council, and other relevant financial regulators and government departments will be in the FCA's words 'active observers, offering their views, where deemed appropriate'.

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[9] ESMA 50-165-2329 TRV Article - EU Ecolabel: Calibrating green criteria for retail funds (europa.eu)

[10] The Devil is the policy detail – will financial regulation support a move to a net zero financial system? | The Financial Inclusion Centre, p66

[11] For example, some individual small companies may not have the same resources to produce verified data on the 'greenness' of their activities. But, in some cases, data on the sector's 'greenness' could be used as a proxy, subject to conditions.

[12] Code of Conduct for ESG data and ratings providers | FCA

[13] A full critique of the FCA's approach can be found in The Devil is the policy detail – will financial regulation support a move to a net zero financial system? | The Financial Inclusion Centre, p82

[14] ESG Data and Ratings Code of Conduct Working Group: Terms of Reference (fca.org.uk)

We agree that developing a meaningful code of practice on ESG ratings while we wait for statutory regulation is critical. Yet we are very concerned about the ability of a DRWG, so heavily dominated by industry representatives, to deliver a meaningful Code of Conduct.

The terms of reference of the DRWG are too weak. And it is unacceptable that such a group is dominated to such an extent by industry vested interests. The whole set up comes across as all a little too cosy and could even furnish ministers with an excuse not to require full regulation.

We urge HMT to use its influence to ensure that the working group has proper civil society representation to generate trust and confidence in any interim code of conduct and prepare the ground for regulation. The FCA should chair this group. If not, it should ensure that it is chaired by an independent person not industry representatives. The FCA should appoint the members and also ensure that half of the DRWG members is made up of independent civil society representatives. Moreover, the FCA cannot allow this DRWG, as constituted, to determine ownership of the Code. At the very least, the regulator must approve the recommendation of Code ownership.

ESG ratings inconsistencies

The FCA does not seem to think that the low correlation between the ESG ratings provided by different agencies is a problem.[15] Yet, surely there is a risk that, if different agencies reach very different conclusions about the ESG rating of the same asset, this will cause confusion and make it harder for investors to make effective, informed choices. It also makes it easier for financial institutions and underlying economic entities to select the most favourable rating.

The low correlation could be something that is addressed as the broad regulatory architecture and taxonomies become better established. But, the inconsistencies in the methodologies will undermine the efficacy of the forthcoming regulation of ESG ratings. We would urge HMT to use its influence to persuade the FCA to:

- Investigate urgently why there is such a low correlation between ESG ratings and publish the results of that analysis.
- Identify the potential detrimental impacts on investor decision making created by the low correlation between ESG ratings.
- Assess the potential for conflicts of interest created by users being able to select favourable ESG ratings methodologies.
- Promote consistent methodologies for ESG ratings.

[15] ESG integration in UK capital markets: Feedback to CP21/18 (fca.org.uk) Risk of harm, p13

Responses to specific questions

1. Do you agree that regulation should be introduced for ESG ratings providers?

Yes, we very much agree for the reasons explained above. But, regulation should also apply to the underlying ESG data that is used in ESG ratings. Concerns have been raised about the integrity and utility of underlying data on emissions produced by economic entities. If ESG ratings are to be trustworthy and reliable, they must be built on a firm foundation of trustworthy and reliable data.

2. (For ESG ratings providers) If your firm were subject to regulation in line with IOSCO's recommendations, and aimed at delivering the four key regulatory outcomes in Figure 1.A, how would this impact your business? Please provide information on the size of your business when answering this question.

We cannot answer this as we are not a provider. But, we should say that we do not agree that the IOSCO recommendations should form the basis of a meaningful ESG ratings regime. The IOSCO approach is too subjective, and narrative and qualitative assessment based. Narrative and disclosure based approaches allow for obfuscation. This approach does not allow users to readily see the degree to which financial institutions finance harm to 'people and planet'.

Relying on transparency or better governance to help users recognise the limitations of various methodologies, or encourage competition between ratings systems, is unlikely to be effective. To reiterate, if financial institutions are to be held to account for and prevented from financing climate damaging economic activities then policymakers and regulators will have to ensure:

- The foundational data on the degree of ESG related harm caused by underlying economic entities (corporate and sovereign) must be reliable and trustworthy.
- It is easy for users such as pension fund trustees, and retail savers and investors (and others such as civil society organisations and public interest media) to identify the degree of ESG positive and negative assets contained within portfolios (whether held in investment/ insurance/ pension funds or bank loan books). Data will not be available for all underlying economic entities so it is important that users are able to see this and that any rating, ranking, or scoring system reflects this including whether proxy data is used where specific data is not available.
- Any system intended to allow users to select ESG positive funds/ products or de-fund climate negative funds/ products is based on robust, consistent methodologies. It is not realistic to expect users (such as pension fund trustees or retail investors) to 'shop around' and determine which is the most trustworthy and relevant methodology. The system will not work if, say, two funds holding similar proportions of climate positive and negative assets (as measured objectively by the degree of emissions facilitated) can receive different rankings, ratings, or scores. Indeed, allowing competition between different ratings methodologies would just enable financial institutions to 'shop around' for the most favourable methodology so creating ratings inflation.
- The use of any ratings in marketing, promotion, or advertising is done responsibly. Of course, the detail of how financial institutions use ratings will be down to the FCA to regulate through conduct of business and other rules. But, the government can limit the

potential for financial institutions to abuse ratings schemes be ensuring the governing legislation is robust.

3. Are there any practical challenges arising from overlap between potential regulation for ESG ratings providers and existing regulation?

The key issue here is not potential overlaps between ESG ratings regulation and existing regulation. Rather, the key issue is to ensure that any ESG rating, ranking, or scoring system is built on reliable and trustworthy foundational data relating to the underlying economic entities financed by financial institutions.

Another priority is ensuring that any new regime for ESG ratings deals with the flaws in the FCA's sustainable investment label proposals. As we explain in our submission to the FCA's consultations, the model proposed by the regulator will not be effective at helping retail investors identify which funds continue to invest in climate damaging economic activities (or indeed support genuine social impact activities).[16]

The FCA's proposals conflate environmental and social goals. The labels are much too narrative and qualitative based. The FCA proposals are not a proper rating system (despite the FCA's own research confirming that consumers prefer clear ratings systems such as 1-5 stars which help them clearly identify good and bad practice).

There is still a chance to minimise the potential harm caused by the FCA's proposed regime. Ensuring that ESG ratings of underlying economic entities is robust and ratings methodologies are consistent would at least give civil society an opportunity to produce objective, trustworthy ratings on portfolios.

It is true that there is a plethora of initiatives relating to ESG, including various reporting and disclosure initiatives. That so much complexity and fragmentation has emerged is unfortunate. But, that is down to government, policymakers and regulators allowing the financial services industry to drive the development of ESG reporting and ratings in a way that reflects their interests rather than the public interest. It is not too late for government to intervene to establish an objective, data based ratings system.

4. Are there any other practical challenges to introducing such regulation?

As outlined above, the main challenge relates to ensuring the foundational data on underlying economic entities is reliable and trustworthy.

5. Do you agree with the proposed description of an ESG rating?

Yes. Any activity which sees to rate, rank, or score the ESG performance (labelled or not as such) of an economic entity, a financial product, financial activity, or collective financial arrangement of any type (fund or loan book) should be covered by the regulation. This should include comparisons

[16] Financial Conduct Authority consultation on Sustainability Disclosure Requirements (SDR) and Investment Labels CP22/20 | The Financial Inclusion Centre

against peer groups (rating, ranking, scoring) and comparative assessments against benchmarks or thresholds.

6. Do you agree that ESG data, where no assessment is present, should be excluded from regulation?

No. We very much oppose this for a number of reasons.

Firstly, the sheer plethora of commercially provided ratings and assessments makes it easy for clients to shop around for the most favourable approach (unless paying for ratings is restricted to investors and savers etc). The complexity also makes it harder for end-users to select the best system. The dynamics of competition in this market will be driven by whoever pays for the ratings. There is a clear risk of financial institutions shopping around for the most favourable rating, leading to 'ratings inflation'. It is important that independent analysts are able to produce truly objective ratings assessments. This will require trustworthy underlying ESG data. Initiatives such as the Net-Zero Data Public Utility (NZDPU) initiative should be helpful. But, unless the production of the input data that may be used as part of the NZDPU is regulated and verified, this will undermine its effectiveness. Indeed, it could result in misleading information being transmitted through the financial system and in the public domain.

Moreover, as mentioned above, proxy data is likely to be needed until more comprehensive data is available. Therefore, the quality and use of proxy data would need to be regulated.

More generally, as explained above, any ratings or assessment system will depend on the quality, reliability, and integrity of any input data. If regulation on ratings is to be introduced, now is a good time to regulate that underlying data. This is too good an opportunity to miss.

7. Do you agree with the proposal to regulate the activity of providing ESG ratings to be used in relation to RAO specified investments?

We have two points to make on this. The first relates to the phrasing used in the regulated activity specifying investments. The definition of investment in PERG 2.6 includes a wide list of financial products and activities meaning the scope is indeed comprehensive. But, while the definition includes bonds, it does not include conventional loans. Banks and other lenders play a significant role in financing the activities of economic entities through loans. If we are to fully understand the degree to which the financial sector enables harm to the environment, then loan books would also have to be assessed and rated.

Second, we would strongly support the inclusion of activities such as voluntary carbon credits from the outset. Serious concerns have already been raised about the misuse of carbon credits and the conflicts of interest inherent in this market.[17]

8. (For ESG ratings providers) Do you know when an ESG rating you provide will be used in relation to a specified investment?

N/A

[17] See, for example: The Verra scandal explained: Why "avoided deforestation" credits are hazardous | LSE International Development

9. **Are there ESG ratings used in relation to anything other than an RAO specified investment which also should be included in regulation?**

See response to Q7 above. We would also reiterate the point that the regulation should apply to ESG data not just ESG ratings.

10. Do you agree that each of the eight scenarios listed above (in paragraphs 3.2, 3.3, and 3.5) should be excluded from regulation?

11. Are there any other exclusions which should be provided for?

On para 3.2, we agree that UK registered charities and not-for-profit organisations in other jurisdictions should be excluded from regulation. But, it is unclear why in the UK this is restricted to registered charities and does not include UK not-for-profits generally. Not-for-profits could play an important role in improving transparency on ESG related harms and in providing a check and balance on the for-profit ratings market.

On para 3.3/ 3.4, we would support intra group ratings being covered eg. in the case of large integrated firms where fund management services are provided internally to an insurance or pension division (which may have its own governance structures). The proposal to exclude own ratings for internal use is interesting. How would regulation deal with cases where internal ratings of an asset are at odds with the ratings used for any public purpose? Shouldn't we expect that ratings used for internal investment decisions be consistent with those used for, say, marketing and promotions?

On para 3.5, while credit ratings which consider the impact of ESG factors on creditworthiness (the *consequences* of climate change) are already covered, this would not necessarily capture the impact of lending activities on the environment (the *causes* of environmental harm).

It is unclear why investment research products are to be excluded. If ESG factors are included in equity research reports, this is for a reason, to influence investor decisions. It is important that a consistent approach is taken to ESG analysis and ratings. The same applies to external reviews particularly in the case of verifications and certifications of ESG labelled bonds. The fact that an ESG bond is verified and certified would be used as a promotional tool by economic entities issuing a bond and financial institutions promoting that bond.

Proxy advisors can exercise significant influence over shareholders. So, it is not clear why they should be excluded from the regulation. If they are not to be specifically referenced in the new ESG regulation, then the existing regulation on proxy advisers should be amended to clarify that it applies to use of ESG data and ratings by proxy advisers in communications and dealings with shareholders.

Again, it is not clear why consulting services are to be excluded. Would this, for example, exclude consulting services provided to a pension scheme? It is easy to imagine a situation where scheme members are concerned about the ESG performance of their scheme and the employer hiring a consultant to conduct a bespoke review. There would be a clear risk here of the consultant, paid by the employer, producing a misleading assessment of the ESG performance of the scheme.

We would support the inclusion of activities such as IPOs.

We agree that academic research and journalism (when investment content is not the main business of the publication) should be excluded. However, specialist comparative information sites should be included.

12. Do you agree with the proposal to regulate the direct provision of ratings to users in the UK, regardless of the location of the provider?

We very much welcome the proposal to regulate the provision of ratings regardless of the location of the provider.

However, we are unclear about the exclusion of 'free' ratings. Many digital based business models provide services for 'free' but generate revenue in other ways such as selling consumer data to other parties. It is not hard to imagine businesses providing free ESG ratings to harvest consumer data to sell onto financial promoters.

Excluding the provision of ratings by UK firms to overseas users seems like a missed opportunity for the UK to play the leading role in driving the development of consistently high global standards.

13. (For UK users of ESG ratings) Are you concerned that this proposal would hamper the choice of ESG ratings available to you?

No. But, to emphasise, what matters is not greater choice of ESG ratings *per se* but that the ratings are of a consistently high standard. Competition will not drive up standards. If anything, depending on who pays for ratings, competition could lead to 'shopping around' for favourable ratings and ratings inflation. So, it is important that the regulation delivers consistently high standards of ESG data and ratings, and addresses conflicts of interest in the ESG information supply chain.

14. Should any instances of direct provision of ESG ratings to users in the UK be excluded from regulation (for example, the provision of ESG ratings to UK branches of overseas firms, or to retail users who are temporarily physically located in the UK)?

No.

15. Are there any scenarios of indirect provision of ESG ratings to UK users which should also be regulated?

No comment.

16. How would the territorial scope proposed in this chapter interact with initiatives related to ESG ratings in other jurisdictions, such as proposals for regulation or codes of conduct?

In a number of ways, other jurisdictions, particularly the EU are ahead of the UK in this field. The EU is ahead of the UK on developing a meaningful ESG taxonomy and ratings. ESMA[18] is ahead of the FCA in tackling greenwashing and producing a framework for assessing the emissions contained within investment portfolios.[19]

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[18] European Securities and Markets Authority

[19] ESMA 50-165-2329 TRV Article - EU Ecolabel: Calibrating green criteria for retail funds (europa.eu)

The UK financial sector remains very influential and the government intends for the UK to be a global centre of green finance. The UK can compete to be a global centre either by being a beacon of high standards or by operating to lower standards to attract less scrupulous market operators.[20] We hope the UK chooses the former path. The proposed regulation provides a great opportunity for the UK to catch up with other jurisdictions and further improve standards on ESG ratings and data.

17. Should smaller ESG ratings providers be subject to fewer or less burdensome requirements?

No. All firms should be subject to the same core principles of regulation. As explained above, competition is likely to undermine standards as firms seek to win business by selling ESG favourable ratings, risking ratings inflation. However, this would not prevent the FCA from operating a proportionate risk based supervision regime.

18. (For ESG ratings providers) What impact would an authorisation requirement have on your business? Please provide information on the size of your business when answering this question.

N/A

19. Do you have any views on an opt-in mechanism for smaller providers?

We do not support an opt-in mechanism for smaller providers for the reasons outlined above.

20. What criteria should be used when evaluating the size of ESG ratings providers?

N/A.

21. What level could the criteria for small ratings providers be set at (i.e., how could 'small ratings provider' be defined)?

N/A.

22. Is there anything else you think HM Treasury should consider in potential legislation to regulate ESG rating providers?

We would reiterate the need to regulate ESG data not just ESG ratings. We would also urge HMT to ensure that civil society representatives are fully involved in the development of the regulation including working groups. As mentioned above, the FCA working group tasked with developing the interim voluntary code of conduct on ESG ratings will be almost entirely dominated by industry representatives.

This marks the end of The Financial Inclusion Centre submission.

June 2023

[20] See: [HM Government: Update to the Green Finance Strategy – Call for Evidence | The Financial Inclusion Centre]