ESG Data and Ratings Working Group (DRWG)
Consultation on the Draft Voluntary Code of Conduct for ESG Ratings and Data Product Providers

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

Research and policy development to promote sustainable, resilient, economically and socially useful financial markets that: benefit the environment; encourage responsible corporate behaviours and create a positive social impact; and efficiently allocate long term financial resources to the real economy.

Ensuring households' core financial services needs are met

Promoting fair and inclusive, efficient and competitive, well-governed and accountable, properly 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 financial markets and services.

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Introduction

The Financial Inclusion Centre is pleased to submit its views on the DRWG Draft Voluntary Code of Conduct for ESG Ratings and Data Product Providers. Note that our submission relates mainly to the overall approach set out in the Draft Code rather than the draft principles (which are basically read across from the IOSCO recommendations) and the role of the DRWG in developing the Code.

We would ask that you share our response with the UK and international observer members of the working group. We note the DRWG says that is not publishing submissions to the consultation and that a feedback statement *may* be shared. For the record, in the interests of transparency and to encourage proper debate, we will be publishing our submission on our website.

Our submission is in two parts. First, we critique the overall approach to the ESG voluntary code, and the governance of the DRWG. Second, we respond to those specific questions which are relevant to our work.

We also include an Annex with general comments on the importance of trustworthy, meaningful, and reliable ESG data, where such data fits within the financial services data supply chain, and the flaws in the current approaches to providing ESG data.

Critique of the FCA's approach to the ESG voluntary code and governance of the DRWG

It is important to put the consideration of the voluntary code of conduct in context. Financial markets and institutions continue to finance, at scale, economic activities which damage the environment.[1] The current approach to climate related financial regulation (and specific regulatory measures) is not sufficient to align financial markets with climate goals.[2] Financial markets and the capital within those markets need to be disciplined, not incentivised, if they are to align with climate goals.

As explained in Annex A, robust, reliable, meaningful, trustworthy ESG data, reporting, and ratings has an important role to play in the challenge of disciplining financial market behaviours. But, there are major flaws in the current approach to producing ESG data, reporting, and ratings.

The FCA has already said that it would welcome taking over the regulation of ESG ratings providers. This is positive. We are urging HM Treasury to give the FCA the powers to regulate ESG ratings and ratings providers as quickly as is possible.

As an interim measure, the FCA announced the formation of the ESG Data and Ratings Code of Conduct Working Group (DRWG) to develop a voluntary Code of Conduct for Environmental Social and Governance (ESG) data and ratings providers.[3]

The FCA is adopting a 'market led' approach to climate related financial regulation and the voluntary Code of Conduct is a market self-regulation measure. IOSCO is also adopting a market led approach to align financial markets with climate goals and its recommendations on ESG ratings also constitute what is in effect a self-regulatory model. Market self-regulation measures and market led initiatives do not have a good track record as mechanisms for improving corporate behaviours in financial

[1] See for example: Time for Action – Greening the Financial System | The Financial Inclusion Centre
[2] The Devil is the policy detail – will financial regulation support a move to a net zero financial system? | The Financial Inclusion Centre
[3] Code of Conduct for ESG data and ratings providers | FCA

markets and services. Unfortunately, reading across the IOSCO market led approach into the UK voluntary code of conduct is unlikely to have much effect on market behaviours.

To have a meaningful impact on market behaviours, voluntary codes of conduct must meet the following conditions:

- **Objectives and outcomes:** the objectives and outcomes set out in the code must be meaningful
- **Standards:** the code standards intended to deliver the objectives and outcomes must be demanding
- **Sign up:** the code should achieve a high level of sign up by those financial institutions and economic entities whose behaviours it is meant to change
- **Compliance:** there should be a high degree of compliance with the standards
- **Transparency:** the 'owners' of the code must be transparent about which of the signatories are complying and not complying with the code, and it must be obvious who has not signed up to the code
- **Responsible use:** market participants (who either use or reference the code in their activities) must use it responsibly
- **Deterrents and sanctions:** there must be appropriate sanctions to deter negative behaviours (even though this is a voluntary code it is still possible to deploy reputational sanctions and regulatory influence to deter negative behaviours)
- **Governance, oversight, and accountability:** there must be robust governance and accountability with regards to the development and ownership of the code, and oversight of the operation of the code.

Unfortunately, the FCA's approach to establishing this particular interim voluntary Code of Conduct means that many of those conditions are unlikely to be met.

The FCA has set very limited objectives and outcomes for the Code of Conduct. The objectives for 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.

The FCA says the work of the DRWG is built around four outcomes (a standard regulatory term for what the regulator wants to see happen). The outcomes are: transparency; good governance; robust systems and controls; and sound management of conflicts of interest. These are not ***outcomes***. These are inputs and processes which, if followed, might create the right outcomes.

If this interim Code is to make a positive contribution to the efforts to discipline market behaviours, then it should produce the following outcomes:

- ESG data and ratings are trustworthy, meaningful and relevant, easy to understand, and of a consistently high standard
- ESG data and ratings are produced and published by providers that operate to the highest standards of integrity and are not subject to conflicts of interest
- Investors and other end-users are able to make effective, informed decisions relating to ESG factors

- Positive climate behaviours and practices are promoted and climate damaging activities are deterred and punished – this should apply to financial institutions and the underlying economic entities those institutions invest in, finance/ lend to, and insure
- Financial institutions and intermediaries, and underlying economic entities use ESG data and ratings responsibly

These are the outcomes we would use to judge the effectiveness of the interim Code of Conduct.

It remains to be seen how many market participants sign up to the Code of Conduct and levels of compliance with its provisions. If the Code is to be effective, there needs to be effective monitoring of compliance with the Code and transparency on which signatories comply and do not comply with the code.

But, it is concerning that the FCA and the DRWG appear to have said little or nothing about oversight and monitoring, or transparency and reporting on compliance with the Code. Nor has the FCA or the DRWG said anything about sanctions for non-compliance or how signatories and other market participants use the Code responsibly.

Moreover, the governance of the DRWG itself is a particular cause for concern. The DRWG has no civil society representation to speak of. The Steering Committee, DRWG, and secretariat is dominated by industry representatives.[4]

Accountability mechanisms are also weak. The FCA intends that meetings will be conducted under the Chatham House rule. Comments, dialogue and feedback within the DRWG's meetings will not be attributable to individuals or the organisations they represent or with which they are associated. The Chatham House rule will also apply in any situation where a formal conversation occurs relating to the work of the DRWG. The DRWG in its consultation has said that consultation submissions will not be made public and says only that a feedback statement *may* be shared to capture key issues raised by stakeholders. Although it does not specify who this feedback might be shared with.

The FCA says that the DRWG should seek to publish a draft of the voluntary Code of Conduct for consultation approximately within six months of the group's first meeting, with the final version of the Code within approximately four months of the start of the consultation. The FCA also says the DRWG should set out its recommendation on the ownership of the Code – the body responsible for hosting and maintaining the Code, as appropriate – when the final version of the Code is published – at the latest.

We are very concerned about the ability of a DRWG, so heavily dominated by industry representatives, to deliver a meaningful Code of Conduct. In our view, the FCA must be more than observers on this group. It must take the lead to ensure this DRWG acts in the public interest to counter the influence of the industry dominance on the DRWG.

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.

[4] 4/4 Co-Chairs, 18/20 of the Working Group Members, and 4/4 of the Secretariat of the DRWG are industry representatives. Annex 2 Draft Voluntary Code of Conduct for ESG Ratings and Data Product Providers

To build trust in the DRWG, and ultimately in any code of practice, the workings of the group should be open to public interest representatives. The Chatham House Rule should *not* apply except when there are genuine issues of commercial confidentiality being discussed. The Secretariat should publish the agenda of forthcoming meetings and actively invite public interest representatives to make written contributions and oral representations at meetings. Minutes of the meetings should be approved by the FCA and published on the FCA website.

Furthermore, the FCA appears to say nothing about what happens if ESG data and ratings providers fail to comply with the Code or indeed fail to sign up to the Code. We must consider how ESG data and ratings are used, as well as produced. The FCA does not discuss what might happen if end-users of ESG data and ratings such as asset managers/investment funds abuse the intention of any Code. The FCA should also prepare guidance for end-users of ESG data and ratings issuance on the use of ESG data and ratings.

Obviously, this is a voluntary, not statutory code so the FCA itself does not have the powers to enforce compliance or sanction breaches. However, some form of sanction will be needed to ensure this voluntary code is not abused. Therefore, the DRWG should be required to consider appropriate deterrents and sanctions for abusing the spirit and letter of the Code.

Response to specific questions

Interoperability

1. **How would the proposed scope of this Code of Conduct interact with initiatives related to ESG ratings and data products in other jurisdictions, such as existing or proposals for regulation or Codes of Conduct? Are there any particular issues that you think might limit its international interoperability with other similar initiatives?**

The issues here is not whether the UK Code has a high degree of interoperability with initiatives in different jurisdictions. Rather, the priority should be to ensure that the UK sets high standards for ESG data, reporting, and ratings and uses its influence to drive up and maintain the highest possible standards in global financial markets.

2. **Taking into account the Code of Conduct's degree of alignment with IOSCO recommendations and the consideration it gives to other international approaches (such as Japan's and Singapore's), do you think the Code of Conduct could and/or should serve as a global baseline for ESG ratings and data product providers?**

As we explain above, the IOSCO recommendations are unlikely to lead to the necessary realignment of financial markets with climate goals. Therefore, it follows that aligning the UK version with the IOSCO recommendations would not result in UK standards being driven up.

Moreover, as we explain above in our critique of the FCA's approach to the ESG voluntary code and governance of the DRWG, we think it is highly unlikely that an effective UK Code will emerge. Therefore, it also follows that unless there are significant improvements to the Code development, it is unlikely the UK Code would be an appropriate global baseline.

Differentiation of ESG Ratings and Data products

3. **Noting the distinction drawn between ESG ratings and data products, is the Code of Conduct sufficiently clear on how its Principles specifically apply to ratings products and/or data products?**

N/A

Forward looking information

4. **Some stakeholders have encouraged there to be an explicit statement as to whether a methodology incorporates forward looking information, such as transition plans. We would welcome views on the proposal to include an action encouraging such disclosure**

It is not clear what it meant by this question. But, we would say that if any ESG 'products' incorporate forward looking information then this should be disclosed and any standards in the Code should apply to this information.

This marks the end of our submission.

Financial Inclusion Centre
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Annex A: The importance of data, ratings, and reporting

It is helpful to summarise the role of data, ratings, and reporting in the financial services supply chain. Figure 1, below, summarises where data, ratings, and reporting are needed if we are to green the financial system, and what is required to ensure that data and ratings are meaningful, trustworthy, and reliable.

Figure 1: The financial services data supply chain

Any collective investment fund/product, insurance fund, pension fund, and bank loan book regardless of the legal or corporate form, is comprised of individual securities (mostly bonds and equities), deposits with specific financial institutions, and other assets such as direct property, and private equity. The green performance of financial institutions ultimately depends on the extent to which the underlying businesses which financial institutions and consumers/ordinary investors lend to, insure, or invest in comply with climate goals.

Narrative reporting or explanations of governance and how economic entities manage climate risks will be helpful for those who want more information. However, narrative styles of reporting can allow for obfuscation and do not allow for objective measurement of progress against climate goals. Therefore, if we are to be able to measure progress, we need hard data on climate performance that can be quantified, consistently measured, rated, and is presented clearly to end-users.

The foundational data and information relating to the constituent assets needs to be of the highest quality and integrity. If that data and information (and how that data and information is presented and reported) is flawed, biased, not relevant, or hard to access and use then it will undermine the ability of end-users to make effective decisions and choices. The utility of any representative marker such as ratings will depend on the quality and integrity of that foundational data and information.

The role of ESG ratings and ratings providers agencies

Financial regulators must begin to assess financial institutions' performance on the basis of the impact of their behaviours and decisions on the environment, rather than the impact of climate change on financial institutions. In other words, the causes and consequences of climate change matter.

The same approach needs to be applied to ESG data, ratings, and ratings providers. Others have raised similar concerns. According to the FCA, MSCI is the most widely used ratings agency.[5] Yet, its ratings measure the impact of external events on a company's prospects not a company's impact on the environment.[6]

There have been many criticisms of the role of ratings agencies in the financial crisis of 2008.[7] One of the main criticisms is that there was an inherent conflict of interest in the credit ratings system itself. Those institutions who were being rated also paid for the rating. Moreover, users of ratings such as banks, insurers, and pension funds had an incentive to select ratings that presented a flattering view of the companies they invested in or lent money to. Banks and insurers had to hold less capital if the companies were given a better credit rating. Investors such as pension funds were able to invest in assets that were over-rated which enhanced the investment return generated – that is, until the market woke up to the true risk involved. Overall, there was an incentive for ratings agencies to inflate credit ratings and downplay credit risks.

Similar conflicts of interest exist in the ESG ratings market. Indeed, conflicts of interest in the ESG sector may be more embedded. With credit ratings, there at least was some financial incentive for some users to avoid credit ratings that were inflated and not a true measure of the credit risk associated with an asset.

With ESG ratings there is a strong incentive for financial institutions to actively select a ratings provider that produces inflated ESG ratings. As the old saying goes, 'follow the money'. As the level of interest and investment in ESG grows, there is a real incentive for financial institutions to misrepresent the compliance of a fund/product with climate goals.

Even where ratings agencies do not set out explicitly to mislead, if the system has embedded biases or allows some ratings providers to adopt a light touch approach, then it will not deliver the necessary transparency and could actually be detrimental.

There is a simultaneous risk of both a proliferation of ESG ratings 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

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[5] See ESG integration in UK capital markets: Feedback to CP21/18 (fca.org.uk), Fig 3

[6] ESG Ratings: A Compass without Direction (harvard.edu)

[7] 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.[8]

It cannot be reiterated enough that the utility of any rating system[9] generally depends on the quality, consistency, and integrity of the foundational data and reporting provided by real economy companies and ESG ratings produced by providers. Allowing financial institutions to select from a proliferation of ratings providers, with very different methodologies, obviously undermines the ability of end-users such as pension funds and retail investors to compare and contrast the climate performance of financial institutions.

The regulation (and any interim Code of Conduct) of ESG data, reporting, and ratings must address those challenges.

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

[9] Or indeed a sustainable investment label of the type envisaged by the FCA. For our analysis of the FCA's label see: Financial Conduct Authority consultation on Sustainability Disclosure Requirements (SDR) and Investment Labels CP22/20 | The Financial Inclusion Centre