Institute for Energy Economics
and Financial Analysis
IEEFA.org

HM Treasury - Consultation on Future Regulatory Regime for ESG Ratings Providers

IEEFA Submission

30 June 2023

Dear Sir/Madam,

The Institute for Energy Economics and Financial Analysis (IEEFA) welcomes the opportunity to respond to the consultation entitled 'Future Regulatory Regime for Environmental, Social, and Governance (ESG) Ratings Providers' and appreciates the significant effort that has gone into developing this consultation.

IEEFA is a not for profit thinktank providing publicly available evidenced-based market analysis in regions around the world, with the clear mission of accelerating the global transition to a diverse, sustainable and profitable energy economy. IEEFA examines issues related to energy market trends and policies.

IEEFA supports the regulatory initiatives undertaken by HM Treasury, continues to follow this discussion closely, and looks forward to contributing in any manner possible. In October 2022, IEEFA published its own report "Greater ESG Rating Consistency Could Encourage Sustainable Investments".[1] The report analysed current ESG rating practices and their shortcomings, and recommended ways to address the issues, including the need for a regulatory intervention in this sector.

Please reach out to discuss any part of this submission and our referenced analyses in further detail.

Kind regards,

Kevin Leung
Sustainable Finance Analyst, Debt Markets
kleung@ieefa.org

Hazel Ilango
Energy Finance Analyst, Debt Markets
hdashini@ieefa.org

Arjun Flora
Director, Europe
aflora@ieefa.org

[1] IEEFA. Greater ESG rating consistency could encourage sustainable investments. October 2022.

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IEEFA's Response to HM Treasury Consultation on Future Regulatory Regime for ESG Ratings Providers

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

Resounding yes. As highlighted in our report and commentaries[2,3], IEEFA considers that a unified approach through baseline and mandated regulation would enable a common language for all market participants. A unified approach would refine necessary areas to reduce the incidence of misconception about the purpose, methodology and results of ESG ratings.

We also highlighted that the arbitrary nature of the ESG rating system, relatively opaque methodology, entrenched bias from input-based disclosures, and de-emphasis on sustainability are problematic when they have the ability to influence trillions of dollars in capital markets.

Therefore, regulating ESG ratings is a crucial step to promote the stability of financial markets and to reduce greenwashing. Regulation determines directed measures to achieve a guided outcome, and is key to safeguarding quality, transparency and governance of ESG ratings, and enhancing access to reliable and consistent ESG data in the financial markets.

IEEFA recommends that the Financial Conduct Authority (FCA) or HM Treasury revisits the effectiveness of the requirements and scope after two years of implementation.

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

1.25 The FCA would not seek to harmonise the varying methodologies and objectives of ESG ratings as a regulatory outcome. The government supports this approach, given the inherent multidimensionality of ESG ratings.

1.8 ESG ratings can cover a wide range of things. For example, an ESG rating can assess an entity's exposure to, and management of, ESG risks (such as flooding risk) and/or ESG opportunities (such as trends like clean technology). Alternatively, it can assess an entity's impact on wider ESG matters (such as a company's impact on air quality due to its carbon emissions).

2.3 This proposed approach is deliberately broad and includes any environmental, social, or governance characteristics.

Disagree. While ESG ratings can cover a wide range of measurements (management of risk, opportunity and impact) and lead to a diverse set of products, it would be beneficial for the financial markets if the FCA defines what an ESG rating should reflect.

A key shortcoming in the ESG rating sector is a lack of comparability, transparency or alignment. ESG ratings are currently assessed using a wide range of factors with little alignment on definitions. Our research shows that the varying methodologies used by ERPs can result in significant disparities, making them difficult to compare and lacking clarity over how ESG integration affects a security or asset[4].

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[2] IEEFA. ESG ratings space needs regulatory intervention. October 2022,

[3] IEEFA. An unregulated ESG rating system reveals its flaws. May 2023

[4] IEEFA. Greater ESG rating consistency could encourage sustainable investments. Page 9. October 2022.

Differing ESG evaluation results would inevitably lead to mispricing of stocks and bonds which, in turn, could mean inaccurate inclusion or exclusion of an asset in investment strategies. These are issues of a flawed ESG rating market that have created divergence and confusion among investors.

There is a need to clearly address and disclose ESG ratings that measure financial materiality based on environmental and social risk (ESG Risk Rating), those that assess the positive or negative impacts of a business's activities on the environment and society (ESG Impact Rating), or both (ESG Impact + Risk Rating).

It is a fine line between ESG risk ratings, ESG impact ratings, and ESG risk + impact ratings, as they are assessed using comparable methodologies and tend to rely on similar metrics. While these various types of ratings are classified as "ESG ratings", they measure different aspects[5].

ESG ratings should be clearly classified according to their measurement definition. For example, the definition of ESG risk ratings and ESG impact ratings should not be conflated. The different type of ESG ratings should have a distinct and defined definition and rating scale across providers.

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

2.5 HM Treasury's proposed scope excludes data on ESG matters where no assessment is present. As such, raw data that is unprocessed is not included. This scope should also not include data which is only minimally processed, for example by formatting or summarising, so long as there is no separate assessment provided. This proposed exclusion would also encompass estimates and proxy data, such as those which aim to fill gaps in a data set.

2.7 Therefore, in this case, HM Treasury considers regulation should be tailored to the greatest potential risk of harm from ESG ratings only.

2.8 HM Treasury and the FCA will continue to monitor the ESG data market and engage with market participants to understand whether further intervention may be necessary. In the meantime, a voluntary Code of Conduct for ESG rating and data providers is being developed by an industry working group

Disagree. HM Treasury should provide a clearer definition of "minimally processed." There should be a distinction in the level of regulatory stringency applied to "rating providers" and "pure data providers" as rating methodologies tend to be more complex compared to the methods used for pure data products.

While ESG ratings pose a greater risk of harm, ESG data, particularly estimates and proxy data (minimally processed), poses the same risk. An ESG rating (output) is only as good as the ESG data (input) it is based on.

Given that ESG rating methodology is at times mechanical and is based on a list of checkboxes, the treatment of even minimally processed data is equally important because it affects the final score. Therefore, data on ESG matters should be included in regulatory scope, to ensure the accuracy, consistency and transparency of even the minimally processed data. Regulation in this aspect would also protect investors by ensuring ESG data providers are adhering to specific legislation.

A good example of ESG data risk is the reporting of Scope 3 greenhouse gas (GHG) emissions, specifically the 'use of goods sold' category. Companies today which are crucial links in the value chain of a (fossil fuel) product and which generate material income from enabling/facilitating its production and delivery to consumers, continue to ignore vast downstream emissions from the final use of that product, based on the

[5] IEEFA. Greater ESG rating consistency could encourage sustainable investments. Pages 5-6. October 2022.

technicality that they do not directly own the product itself. This could be a bank ignoring its 'financed' emissions, or a gas transmission system operator ignoring its 'transported' emissions[6]. In such cases companies could be reporting a figure for Scope 3 emissions which is 100 times smaller than it should be. A lack of regulation of ESG data providers would mean that such reporting tactics can continue unchecked and unchallenged, causing inconsistent or misleading ESG ratings driving flawed investment decisions and the mis-allocation of capital.

Although more companies are expected to report ESG data in accordance with new standards, and this may result in lower estimation risk, time is required for data to be high quality and the reporting entity to be familiar with the required data. Regulation on ESG data would ensure a higher quality ESG rating outcome, resulting in a more credible ESG rating ecosystem.

In IEEFA's view, while a voluntary code of conduct provides flexibility to the firms, subjectivity would still be prevalent as the code may not be widely adopted. A voluntary code of conduct should only be applied in the interim[7]. Mandatory adoption of the code facilitates credible ESG data.

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

Agree. Regulation should capture the provision of ESG ratings when they are used for a broad range of activities which relate to financial services. This will provide a clear direction and understanding of how ESG ratings are used.

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?

Disagree with the third scenario (paragraph 3.5). The exclusion of second-party opinions (SPO) would create a regulatory loophole. Many SPO providers publish the assessment reports for public use of debt investors and other stakeholders. SPO reports may not be in the form of a 'score' or 'rating' but often contain a lot of processed information that overlaps with or acts as input for ESG ratings. The services are often provided under an 'issuer-pays' business model and thus are more exposed to business separation or conflict of interest concerns.

We agree that investment research products can be excluded, but to avoid another regulatory loophole, the Treasury should consider setting clear thresholds and safeguards to identify/determine any research reports that contain 'ESG rating'-like assessments or opinions. These reports may be branded as investment/sell-side research products but, given the content, should be under the regulatory scope for consistency.

HM Treasury should be more nuanced in determining the scope to avoid confusions in the markets and loopholes. The various business models of the ESG rating market should be acknowledged as they very much represent a spectrum of degree of exposure to risks or concerns in the markets highlighted earlier. For example, 'issuer-pay' products are much more exposed to business separation or conflicts of interest. 'Issuer-pay' products usually have more public good characteristics and should therefore be subject to the highest level of disclosure requirements. For 'subscriber-pay' products, there should be acknowledgement of the distinction between products that are intended for a wide audience of subscribers, and products that are tailored for only certain subscriber(s), which may be more private. Clear thresholds should be defined.

[6] IEEFA. Hiding in Plain Sight — European Gas Pipeline Companies' Greenhouse Gas Emissions. December 2020.
[7] IEEFA. Japan leads governance of ESG data and ratings sector but pliant rules a letdown. February 2023.

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

No, smaller ERPs should not be subjected to fewer requirements. A minimum standard should be required for all ERP types to level the playing field. By establishing a baseline or equal standard, it will ensure ERPs will follow the same requirements and standards, fostering fair competition and preventing potential differences in rating practises or methodologies.

One of the main concerns in the ESG rating sector is the lack of comparability. Therefore, applying a consistent regulation across ERPs would facilitate the standardisation of data quality, methodology and ESG rating outcome.

While maintaining a uniform standard may be burdensome for smaller ERPs, regulators could consider waiving fees for smaller ERPs to alleviate disproportionate financial burdens. This would encourage continued competition and innovation, while ensuring minimum standards are introduced across the market.

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

1.14 Therefore, HM Treasury considers there is clear benefit to be gained from improving the transparency of methodologies, governance, and processes of ESG ratings providers. These outcomes could be brought about through regulation.

IEEFA agrees that there is a clear benefit in improving the ESG rating sector through regulatory intervention. However, this version of the consultation did not address specific ways how the methodologies, governance and processes of ESG ratings can be improved. IEEFA makes some key recommendations below to improve the ESG ratings system. Our report provides further explanation and references are added to each point below[8].

ESG Rating Methodology

- Detailed rating methodology should be shared publicly but weightages or a proprietary algorithm should be confidential information for regulatory authorities like the FCA or HM Treasury. This would provide more clarity on the criteria applied in identifying key ESG factors and subsequently help investors understand changes in (upgrade/downgrade) and the calculation of ESG rating scores.

- ERPs should be subjected to a third-party audit or assurance by a regulatory authority to assure compliance and consistency of methodology[9].

- Any changes to the methodology or internal guidelines should be independently validated and/or subjected to public consultation[10].

The abovementioned suggestions are pivotal. A 2021 Bloomberg Businessweek[11] analysis of 155 ESG rating upgrades by MSCI showed that about half of the companies were upgraded due to underlying methodology

[8] IEEFA. Greater ESG rating consistency could encourage sustainable investments. Pages 12-14. October 2022.
[9] IEEFA. An unregulated ESG rating system reveals its flaws. May 2023
[10] IEEFA. An unregulated ESG rating system reveals its flaws. May 2023
[11] Bloomberg Businessweek. The ESG Mirage. December 2021.

changes. Two years later, MSCI imminently downgraded 31,000 funds due to a revision it its rating methodology[12]. There was limited transparency over what caused the upgrades and downgrades, and public disclosure on such matters are important to investors who rely on MSCI's rating methodology. Regulators should require ERPs to provide concrete and structured evidence to support the ratings assigned, the validity of their criteria and how they modify these assessment conditions[13].

- A single metric for an ESG score may not be appropriate for investors with a specific ESG focus, such as climate change or human development. A mandatory reporting of each E, S, and G pillar separately, as well as sub-key components that influence these scores, would accurately reflect a company's key drivers and risk in terms of ESG performance[14].

ESG Rating Model Credibility[15]

- Every ERP should publish their average one-year ESG rating transition rate over a 3-year period, on their respective websites.

- Publish Trailing 12-month ESG transition rates despite having limited transitional probabilities for transparency.

The ESG rating transition rates will be an adequate proxy to measure performance of an ERP. The frequency and magnitude of rating changes as well as the stability and share of unchanged ratings over time are important factors to consider in evaluating the reliability and effectiveness of ERP.

- Provide a standard accuracy rate for evaluating the performance of ESG score model. Credit rating agencies (CRAs) undertake a similar approach, by disclosing the accuracy rate (Gini coefficient). As with most statistical measures, any power statistics is sensitive to the sample size.

- ERP should carry out periodic review of all published ESG ratings. Any changes in ESG rating actions (upgrade/downgrade) should be disclosed for public access.

The accuracy and credibility of ESG ratings is usually reflected in year-on-year ratings provided on an ongoing basis, with no steep or drastic changes since its initial rating assignment. Requiring providers to back-test their methodologies against their accuracy rate results could help improve ESG rating quality and encourage ERPs to constantly improve their ESG rating performance model or assessment[16].

ESG Rating Process

- Prior to conducting ESG rating assessments, ERPs should hold a management meeting with issuers, whereby ERPs could interview management and verify their findings. CRAs undertake a similar process where the credit analyst has the opportunity to interview internal management teams and inspect the issuer's operations strategy and rating aspirations.

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[12] MSCI. Enhancements to MSCI's Fund ESG Ratings. March 2023.
[13] IEEFA. An unregulated ESG rating system reveals its flaws. May 2023
[14] IEEFA. Greater ESG rating consistency could encourage sustainable investments. Pages 14-16,23. October 2022.
[15] SEBI's proposed guidelines specify disclosure requirements related to ESG rating model including average one-year ESG rating transition rate, compensation arrangements, rating classification (risk or impact), and more. SEBI. Consultation Paper on Regulatory Framework for ESG Rating Providers. Page 22. February 2023.
[16] IEEFA. Greater ESG rating consistency could encourage sustainable investments. Page 23. October 2022.

Relying solely on company disclosures or third-party data without further engagement leaves room for companies to manipulate their ESG credentials, increasing the risk of greenwashing.

The aim of management interview is to gain a better understanding of how the sustainability reporting was prepared, how the company performed, and what the company expects for the future in terms of ESG performance.

However, securing management meetings with issuers poses greater difficulties within the subscriber-pays model, compared to the issuer-pays model. Consequently, this could result in data gaps stemming from insufficient information regarding the issuer's ESG credentials.

In this scenario, the ERP may need to rely on sending questionnaires to the issuer instead. However, there is a possibility that the issuer may prioritize responding to the ERP that is more likely to assign a higher ESG rating, essentially engaging in what is known as 'rating shopping'.

While an issuer may not be contractually bound to provide information to the ERPs under the subscriber-pays model, this can be overcome by giving a non-comply rating such as "F" when a company does not respond to questions or data requirements requested by ERPs.

A non-comply rating would be helpful in preventing or indicating where there are cases of 'ratings shopping'. For example, where one ERP provides a rating but others have reported a "non-comply", that indicates that a company was selective in which ERP it deals with. A non-comply rating also incentivises companies to prepare and provide the necessary information as required for an ESG rating assessment on a timely basis.

- Any published or changes in ESG ratings should go through an internal and external rating committee. Members of the internal and external rating committee should also be disclosed on the website to improve the governance of the ESG rating providers.

  Once the committee has come to an agreed rating, the issuer should be granted an option to appeal. The appeal process should only take two days or less. After this period, the rating should be published to the public and/or given to the issuer as an official ESG rating.

  While ERPs may argue that their business model is different from credit rating agencies, implementing such process will ensure fair and unbiased influence over the rating process. This also mitigates the issuer-pays conflict of interest because the committee (particularly the external committee) has no revenue goal.

  Furthermore, the rating committee should include independent members (i.e. not related to a rating provider) and sustainability experts[17] to strengthen the ERP's internal controls, corporate governance mechanisms and the long-term sustainability in the final ESG rating.

ESG rating providers should also be subjected to a more rigorous and structured approach in carrying out internal processes, mainly in the activity of the rating deliberation.

[17] IEEFA. More credit downgrades imminent under climate change but credit model overhaul yet to be seen. April 2023

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About IEEFA

The Institute for Energy Economics and Financial Analysis (IEEFA) examines issues related to energy markets, trends and policies. The Institute's mission is to accelerate the transition to a diverse, sustainable and profitable energy economy. www.ieefa.org

About the Authors

Kevin Leung
Kevin Leung is Sustainable Finance Analyst, Debt Markets, Europe.

Prior to IEEFA, Kevin worked for roles in Credit Ratings and Sustainable Finance at Moody's. As an experienced fundamental analyst, he has developed his expertise into ESG integration in credit analysis and comprehensive ESG assessments adopting a double materiality approach.

Kevin holds a Master's Degree in Finance from HEC Paris and a Bachelor of Science Degree from the University of Warwick. kleung@ieefa.org

Hazel Ilango
Hazel Ilango is an Energy Finance Analyst at IEEFA covering debt markets. Her past work has actively focused on data analytics and credit analysis while developing credit related model for fixed income instruments.

Prior to IEEFA, Hazel was an analyst in a leading credit rating agency in Malaysia and South-East Asia, covering the data and credit analytics segment with an ASEAN focus (Association of Southeast Asian Nations).

Hazel holds a BSc Mathematics degree from the University of Wisconsin–Eau Claire.hdashini@ieefa.org

Arjun Flora
Arjun Flora is Director, Europe, at IEEFA, where he is responsible for leading and building the Europe team and working with partners to maximize impact. As a research analyst, he covers several topics relating to the energy transition in Europe, including sustainable finance, gas infrastructure, power utilities, energy markets and consumption trends. Since joining IEEFA in 2020, Arjun has authored numerous reports and provided expert briefings to various stakeholder groups. He has also been quoted on European energy issues by leading business and news outlets.

Arjun previously worked in energy technology investment banking at Alexa Capital and Jefferies in London. He holds a Master's degree in Engineering from the University of Cambridge. aflora@ieefa.org