ALLEN & OVERY

ESG Ratings: Who rates the ‘raters’?

Environmental, social and governance **(ESG)** ratings are increasingly used by investors, lenders and regulators to assess the sustainability performance of companies. They can, for example, assess an entity’s exposure to, and management of, ESG risks such as flooding, as well as ESG opportunities such as access to and use of clean technology. They can also assess an entity’s impact on wider sustainability considerations, which might include the company’s impact on air quality due to its carbon emissions. In 2020, it was found that 65% of institutional investors use ESG ratings at least once a week.[1] This sits against a backdrop of a growing volume of assets under management incorporating ESG considerations (projected to exceed US$53 trillion by 2025, representing over a third of all global investments).[2] ESG ratings can therefore significantly influence a company’s cost of capital, access to markets, reputation and stakeholder relations.

The provision of ESG ratings is, however, largely unregulated, unlike credit ratings which are subject to oversight by regulatory authorities such as the U.S. Securities and Exchange Commission and the European Securities and Markets Authority **(ESMA)**. To complicate matters, ESG ratings are inherently multidimensional, where scrutiny moves beyond the creditworthiness of an entity or financial instrument.

As a result, questions have emerged about the quality, consistency and transparency of ESG ratings. With a major ESG ratings provider, MSCI, set to downgrade 31,000 exchange-traded funds and others from their existing ‘AA’ or ‘AAA’ ESG ratings, there are growing calls for greater regulation.

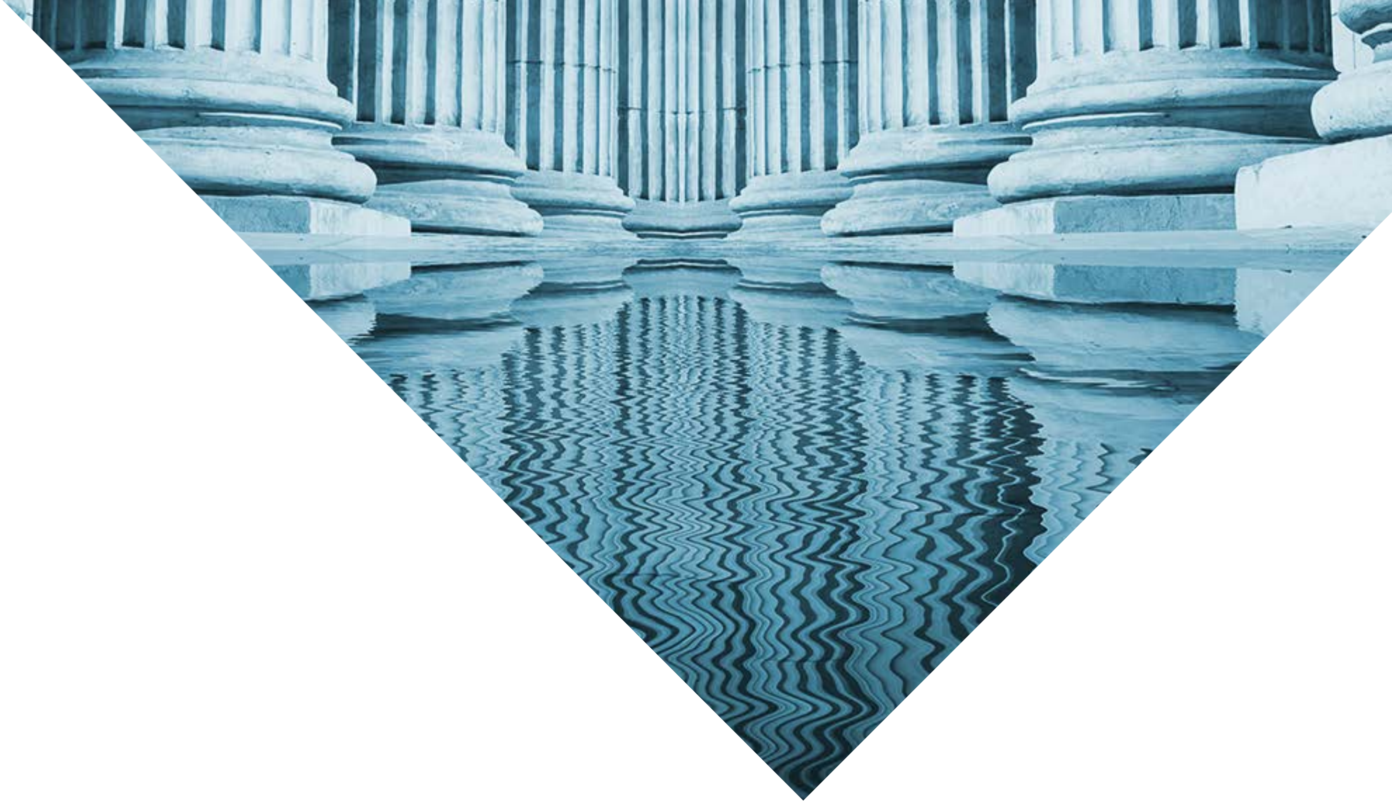
The current (self-) regulatory landscape

At present, there is no single source of regulation in the EU or the UK mandating how ESG rating providers create, and apply, their rating standards. As a result, different providers adopt different methodologies, definitions, indicators, sources and weightings to measure and score ESG performance and risks. While certain ratings providers such as ‘ESG Book’ benchmark companies against international frameworks, such as the recommendations and guidance produced by the Task Force on Climate-related Financial Disclosures,[3] others have adopted their own bespoke framework based on a list of factors. As a result, ESG ratings among providers can have little to no correlation.[4]

Furthermore, coverage between various industries and geographical areas is often uneven. Conflicts of interests can also emerge, with ESG ratings providers seeking to advertise other services to financial institutions and corporates whose financial instruments they rate, such as consulting, advisory or research services. The ESMA has deemed the sector ‘ a fertile ground for potential conflicts of interest’.[5]

The lack of consistency and comparability between ESG ratings adopted by different providers has created confusion and uncertainty for issuers of and investors in ESG-linked products. Together, these factors undermine ESG ratings as a tool to gauge sustainability performance. More broadly, the inconsistency of ESG ratings may lead to issues down the investment value chain, such as misallocation of investment based on underdeveloped ESG rating-based indices, and/or the greenwashing and mis-selling of products purportedly scoring strongly with ESG ratings.

[1] https://www.sustainability.com/globalassets/sustainability.com/thinking/pdfs/sustainability-ratetheraters2020-report.pdf
[2] https://www.bloomberg.com/professional/blog/esg-assets-may-hit-53-trillion-by-2025-a-third-of-global-aum/
[3] https://www.esgbook.com/insights/esg-regulatory-hub/tcfd-solution/
[4] https://www.esginvestor.net/esg-ratings-face-uphill-battle-despite-downgrades/
[5] https://www.esma.europa.eu/sites/default/files/trv_2021_1-esg_ratings_status_and_key_issues_ahead.pdf



What is being contemplated?

Given the growing influence of ESG ratings, there is a need for more regulation and coordination to address these concerns, and to ensure that ESG ratings are robust, reliable and relevant for the market.

Globally, the International Organisation of Securities Commissions has signalled that ESG data and ratings should be placed under the remit of securities regulators.[6] Momentum is also growing in individual countries.

In December 2022, the Japanese Financial Services Agency finalised a code of conduct for ESG rating providers, setting out principles as to the quality of ESG ratings and data to be provided, policies to be adopted to ensure transparency, independent decision-making and potential conflicts of interest.[7] This code of conduct is voluntary, and it remains to be seen which of the major ESG rating providers will endorse it.

A similar effort to develop a voluntary code of conduct is currently underway in the UK,[8] with the Financial Conduct Authority due to publish voluntary standards in the summer of 2023. Furthermore, in March 2023, HM Treasury launched a consultation seeking views from stakeholders on the regulation of ESG rating providers.[9] This consultation proposes bringing UK and overseas rating providers, which provide ratings to UK users, under the remit of the Financial Services and Markets Act 2000.

At the same time, the Treasury recognises that, as the ESG rating market is relatively nascent and will continue to develop, regulation should be proportionate and targeted to ensure effectiveness. Accordingly, the Treasury is proposing the capture of direct provision of ESG ratings, where the rating is provided to a UK user who has paid for that rating, either on its own or as part of another service or bundle of products. It does not intend to capture scenarios where a UK user accesses a free rating. Notably, to ensure interoperability and harmonisation, if other jurisdictions introduce similar regulations, the Treasury would consider whether to recognise those regimes.

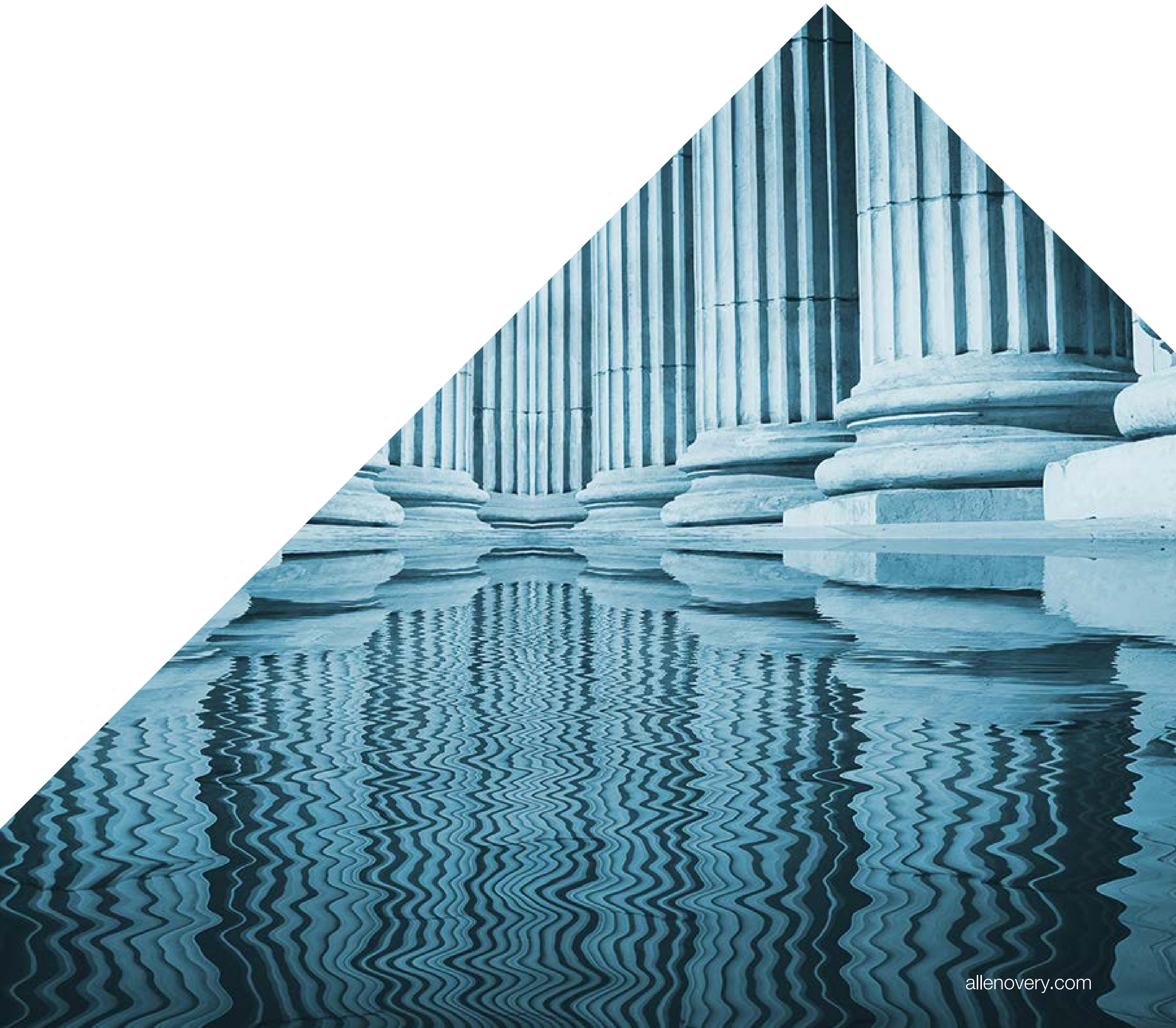
Similar consultations are underway in the EU, where the ESMA has suggested that a legal framework be developed, common to all products, issuers and securities, to ensure consistency in ESG ratings across the market.[10]
A centralised registration system for all ESG rating providers is also proposed, under which they would be supervised by an appropriate public authority. Again, a proportional approach is suggested with larger rating providers subject to additional organisational and conflict of interest requirements. The European Commission is reportedly planning to publish a legislative proposal on the regulation of ESG ratings on 13 June 2023.[11]

[6] https://www.iosco.org/library/pubdocs/pdf/IOSCOPD717.pdf
[7] https://www.fsa.go.jp/en/news/2022/20221215/20221215.html
[8] https://www.fca.org.uk/news/news-stories/code-conduct-esg-data-and-ratings-providers
[9] https://www.gov.uk/government/consultations/future-regulatory-regime-for-environmental-social-and-governance-esg-ratings-providers
[10] https://www.esma.europa.eu/sites/default/files/library/esma30-379-423_esma_letter_to_ec_on_esg_ratings.pdf
[11] https://www.responsible-investor.com/ec-expected-to-publish-esg-ratings-regulation-proposal-in-mid-june/

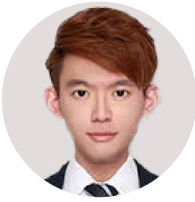
Impact on financial institutions and corporates

Were these proposals to be implemented, we could expect increased clarity and transparency over what methodologies are used, as well as how they are applied to calculate ESG ratings. Financial institutions, investors and lenders would likely have greater confidence investing in ESG-linked investment products such as Article 8 and 9 funds, knowing that the underlying assets have been appropriately assessed against objective, market-standard benchmarks. Greenwashing risks may also be reduced.

That said, these proposals could raise the costs and compliance burdens for financial institutions and corporates, which would have to disclose more information and data on factors such as ESG-related risks in their supply chains. Greater investment may be needed to prepare large corporates' internal systems, processes and capabilities to collect, analyse and report on ESG-related information.



Your core contacts

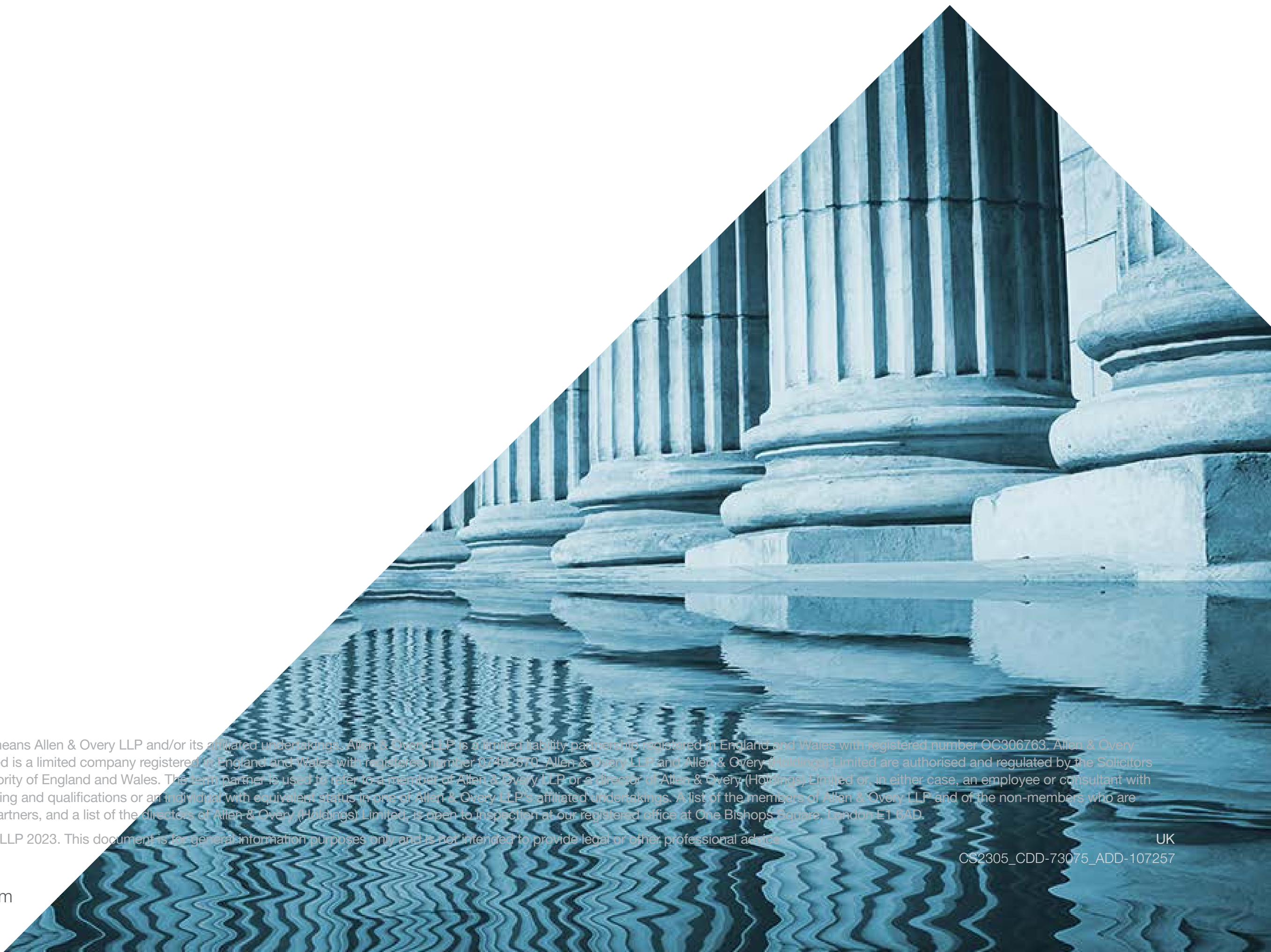


Matthew Townsend
Partner
London
Tel +44 20 3088 3174
matthew.townsend@allenovery.com

Danae Wheeler
Associate
London
Tel +44 20 3088 3505
danae.wheeler@allenovery.com

Ming He Tan
Associate
London
Tel +44 20 3088 1910
minghe.tan@allenovery.com

Should you have any questions on the matters discussed in this article, please get in touch with the authors or your usual A&O contact.



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