Meeting Minutes for the APPG on Environmental, Social, and Governance

Topic: ESG Ratings and ESG Data in Financial Services

Date: Wednesday 8 June at 10:30 (Hybrid)

Parliamentary attendees:

Alexander Stafford MP, Chair of the APPG on ESG

Guests:

Nick Bonsall (NB), Chair of IRSG ESG ratings workstream

Peter Beardshaw (PB), Managing Director, Accenture, European & UK Sustainability Services Lead

Corporate attendees:

Neil Acres, Global Head of Government and Regulatory Affairs, MSCI Inc.

Jack Bowles, Investment Director, Schroders

Richard Collins, Founder and Managing Director, CSR Accreditation

Adele Gilbert, Head of Communications & Marketing, Shore Capital

Jimmy Greer, VP ESG Outreach and Research, Moody's ESG Solutions

Dan Harris, Partner, Chancery Advisors

Ling Sin Fai Lam, Director – ESG and Sustainability, Shore Capital

Paul Southall, Head of Sustainability, Rigby Group

Eva Vogt, Head of ESG and Impact & Partner, EMK Capital

External and industry body attendees:

Prof. Jill Atkins, Chair in Financial Management, Sheffield University

Dr Heather Buchanan, Director of Policy, APPG on Fair Business Banking

The meeting starts at 10:30am.

AS: My name is Alexander Stafford, and I am the Chair of this All-Party Parliamentary Group. So once again I should welcome you all here for our first hybrid meeting for a couple months now and the basis of today's presentation is ESG rating data from a joint report published in May by the International Regulatory and Strategy Group, the IRSG in partnership with Accenture. So, joining us with those on Zoom but not in person today are Nick Bonsall and Peter Beardshaw. If you want to introduce yourselves Nick and Peter.

NB: I'm Nick Bonsall, I am a partner at Slaughter & May, and I've been chairing the sub-committee of the ESG Committee at IRSG that's specifically interested in looking at ESG ratings.

PB: I'm Peter Beardshaw, Managing Director at Accenture and part of our global sustainability business for banking, so bringing today a perspective about how the data is going to be ingested and used.

AS: Thank you. We will start by having a few minutes presentation by both of them and then we're going to have a wider discussion about this. The main sort of agenda points we hope to cover today at this meeting is encouraging transparency and consistency in ESG ratings, proving the quality and quantity of ESG data globally, coordinating and collaboration between international bodies and importantly, the future regulatory environment. Obviously, this subject is multi-dimensional and there are areas such as investment impact, investment protection and proportionality. So, I'm very happy to go that way but let's try and head our stations first and then do a deep dive on those before we do a bit off-kilter like sometimes I know we do, all important discussions. Around this time last year the Financial Conduct Authority (FCA) published disclosures and among the lines of inquiry was the extent of regulation in rating requirements and should the UK pursue a better practice model and should the FCA be mandated to regulate these firms directly.

So, I'm very pleased to be hosting this group today shortly before the regulator is due to publish feedback on responses received. I know that much of the content of the IRSG/Accenture report dovetails into the FCA transparency.

Joint presentation by Nick Bonsall and Peter Beardshaw

NB: ESG factors are an increasingly important part of decision making and ESG ratings are an objective tool that allows people to understand the ESG credentials of securities that are being evaluated. Like in any nascent market, there is concern of whether people understand what the ratings are doing, whether there is a consistent approach to the methodologies people use and whether there is transparency disclosure around the rated products so as to understand what they really mean (i.e. are they truly objective and do people understand the objective criteria that is being evaluated). The report went across the entire market to gather information of how the market operated, where it was innovating/developing, and where the risks were (e.g. greenwashing).

The report raises a number of recommendations. The most important thing is that it concludes that, in terms of whether there should be regulation of ESG rating provision, that this is the right time for some degree of regulation to be introduced. The main justification for that was that although a nascent market, the risk is that there is currently no requirement for ESG rating providers to be transparent about the methodologies they use and there is no requirement for ESG rating providers to apply the methodology they put out there consistently. If the market doesn't understand the methodology that the ratings providers are using, then the risk is that the products aren't doing what they say they are or that the investors can't trust the product rating that has been disclosed.

Aside from that key point, there are two important caveats to mention. First, the importance of obtaining a degree of international coordination on the matter, as it is not a UK-specific marketplace, it is a global marketplace where investors across the world are looking for places to invest and many of the ratings providers and the investment firms are operating globally. The more we can have a degree of global consistency and coordination around the way regulation works, the better. Second, regulation is a useful tool to increase objectivity and reduce the harms that could otherwise arise in the market, but it also brings a significant burden for firms that are subject to it.

The greater the element of regulation the greater the barrier to entry in the market and the more that you can stifle innovation. Lots of firms are trying to introduce new and innovative ways to assess three quite different components in ESG that are quite difficult to quantify although some aspects of ESG are quite difficult to quantify. Therefore, the risk of over regulation and picking up the regulatory framework that applies to credit rating agencies and applying that to this market hinders innovation. Thus, we urge against that and highlight that there are a couple of areas where there are significant benefits that could come from creating consistency and transparency around methodologies through requiring providers to follow those methodologies systematically and consistency.

PB: I'm unsure if we are preaching to the converted here in terms of extending the FDA's remit to regulation of ESG rating providers and then also helping their collaboration with the EBA. I wanted to emphasise how the ratings are then used in an organisation because you've got boards relying on this data, feeling whether they are investing in green/socially acceptable funds, whether their lending practices are aiding the transition to Net Zero. All of that is based on the corporate footprint of the organisations they are lending to and transition plans that they've got.

The transition plans are one of the big, interesting things when it comes to ESG ratings because transition plans fit with E (environmental), but it could also fit with S (social). Working out how you are going to manage the future of a firm that does not currently have a good 'E' rating, for example, but has ambition to become more environmentally sustainable or aid in the transition to net zero, this ambition has to be reflected in the ratings which brings extra complications to the rating calculation. Within an organisation, such as a bank, they do not take a rating at face value, they compare the rating with their own sources of information, potentially artificial intelligence tools analysing data, and then adding that all together and then coming up with some sort of criteria. Then they compare that with the rest of the portfolio and traditional risk factors and lending criteria, and the liquidity in their portfolio, and try to balance all of these things when they are making lending decisions.

When we think about the start of the supply chain, that one piece of ESG rating isn't understood and no one has said that 'we want all the methodologies to be the same', they just want to understand the transparency and mechanics of how that is being constructed, which can then be imported to the organisation, added with other factors and used to assess whether a fund is green or not. Therefore, it is a really important part of the food chain and if you get the start of the food chain wrong, then of course you will have a butterfly effect through the rest of the organisation.

NB: A really interesting point that emerges from that and was highlighted in the report is the lack of clarity that can exist in the market between what different ESG rating products are trying to achieve. By this I mean that the difference between an ESG rating product that is assessing the ESG impact that the company might have vs an ESG rating product which is assessing the ESG risks to the long-term sustainability of that company.

For example, a company may not itself be exposed to climate change risk, it might even benefit from climate change risk, therefore from one ESG rating product's perspective they might end up with a good or high rating but that same company may be one that contributes significantly to climate change risk through emissions. So, from another ESG rating product it might end up with a lower rating. It is incredibly important for the market to understand whether an ESG rating is showing a good company and people have to understand what that ESG rating is actually assessing.

PB: Because the banks are struggling with climate stress tests which are essentially protectionist because you are trying to work out whether the impact of climate on the asset they hold, whether they have enough capital put aside to protect against the problem. That's not helpful to the ethical and social side of net zero contributions where you want to know who I am lending to and whether I am making a difference to that corporation.

They might be holding assets in flood planning and under a certain scenario that is a big stress and you put capital aside because that is going to be underwater whereas what you really want is to be lending to that organisation either to help reduce carbon emissions so it doesn't flood or to help them move that property portfolio out of flood planning. So, these are the tensions that this data provides to an organisation

NB: The final point is around data. I think there are two things to mention regarding data. There is no suggestion in the report that near ESG ratings data providers should be brought under the scope of regulation, the regulation should be with the organisations who use that data, evaluate it, and use it to create a score/rating assessing the ESG impact/risk that an asset or security might have. The second point is that there are many improvements being made in the way that ESG reporting and ESG data comes out of various different companies in the market, but it is genuinely very difficult to consistently, whether you look at this from a UK-perspective or a global perspective, force all organisations to report different data points that will be relevant to ESG ratings.

For that reason one of the quite important factors in obtaining high quality ESG rating products is going to be enabling a proper contractual relationship to exist between ESG ratings providers and the organisations that they are rating and enabling them to know and understand those companies because it may well be that through data sharing bilaterally between organisations and ESG rating providers it is more possible to get the objective data that can then feed into the ratings. There is a great deal of work in the industry dedicated to improving data quality across the industry.

Discussion begins

AS: What do rating agencies say about your actual report? As I understand you don't care about the data, just how the rating agencies deal with the data. Surely if I were to waive a cynical hat, you just want them to reveal their methodologies and their sort of algorithms which would almost undermine these rating agencies. How are you working with the rating agencies, or frankly do you think that rating agencies shouldn't be there? I understand it's controversial but why not?

NB: Two things. First, certainly from our perspective as a committee, the rating agencies have been, or at least Moody's have been, positive towards the recommendations that have been made here. I think it is important to recognise that in the world of credit ratings at the moment the regulatory framework does require the disclosure of all of the different methodologies that credit rating agencies use, and it does require these rating agencies to apply these methodologies in a consistent, rigorous, and systematic way. So, the regulatory framework in that space deals with this specific point. In some ways what we are saying is that that is a good piece of regulation which could be carried across and could provide greater objectivity and transparency around how ESG rating products work.

PB: I think specifically on this point, the transparency of methodology for us is a great opportunity as well. We want our opinion to be one that people choose over other rating providers so that transparency of the methodology but also the data source of where the data is coming from are two really important pieces for us. Underneath exposing how the methodology works, the secret source as it were, there is so much work that goes on from the analyst to the methodology team to the ratings, to the way we think about sectors, and people may in different organisations think about those things in different ways. We do it in a particular way and that is where that choice and diversity comes in but for us that clarity and transparency, more of it would be great for us.

Contribution: We agree on some points and disagree on some other points. To start, from a principles perspective we fully agree and subscribe to the fact that transparent methodologies, having users understand how you get to the rating, and what the rationale is behind is imperative. We also fully agree on consistent application of methodology, users being able to understand how the rating is being assigned consistently across the different ratings that you assign is something that we can agree with and the government's process around the rating. On the fundamental principles for regulation, or a call for regulation, there is broad agreement. I think that where we stand on that pathway to regulation is we're not at the stage where we think regulation is necessary at this point in time.

If you look at all the different sectors where regulation has been introduced over the years, benchmarks, credit rating agencies, all began with a code of conduct which really set the scene in terms of the principles and the standards by which everybody was expected to comply with. What they did was, it was the first stage of regulation that allowed the different participants to understand who is actually in the scope, what are the key principles you need to be regulated under, and you don't go with this hard regulation which essentially freezes the market at a point in time which is exactly what has happened. You also prevent the negatives associated with competition, like you heard with bringing in new regulation which has had zero impact on the credit rating industry which is confined to a couple of providers. So, all these new providers, all these new innovative ways of issuing ratings are going to be cold because you are going to have a significant upload from that point in time.

So, I think our pathway is still very much at this point in time saying that we understand the regulation path is necessary, certainly for ratings, start with a code of conduct, introduce that first, get them understanding and a subscription to who knows what. Coming up with a harmonised code of conduct is the first step in taking that path towards regulation.

I think where we disagree is, for example, on your point about having a contractual relationship with the ESG provider. I think, to make everybody aware, the issue ratings market is very heavily subscriptions based, so what we have is very different to the credit rating agency model, which is issuer pays, whereas ESG is investor/subscriber pays. I think we have to be careful of creating a perception that this is a life-grown issue, to have a view on something that is being published on, we certainly encourage engagement with the issuer.

For example an issuer has access to our methodology and every single data point that they have they can engage with us et cetera, that is a step further than saying issuers have a right to intervene or to have a view on your opinion before you publish it and I think that is a step too far and reduces that conflict of interest. So, the introductory point from my side is I think we agree on a lot of the principles, but we just see a different pathway, we're just cautious about introducing conflicts of interest which may exist in other sectors into ours.

AS: Would you like to come back to that, or should I bring someone else into this?

NB: Just on the final point I would quickly observe I don't actually think we're in disagreement on that. I think the comment about contractual relationship is not a comment on issuer v. subscriber pays it was more providing that greater access to data from the rating entities.

PB: My comment would be what is really the difference between a code of conduct and regulation is regulation has got a spectrum as well and I think what we observed is the value, and it's not stifling new entrance, because the regulation sets out a framework that everyone understands and therefore it is actually easier to start off with a competitor or to spin up within an existing organisation if that framework is then clearer.

Contribution: Keeping in mind the costs, the cost of regulation, regardless of what the size of the framework is, is extensive. So whilst you might have clarity in terms of principles which I would argue you get from the code [of conduct], you avoid those heavy start-up costs for a new provider coming in with significant FCA fees, even in the millions, and having all those controls in place once you're an FCA regulator so that it doesn't matter necessarily the extent of the regulation you have a C-management regime, you have controls that are required and that's where expense comes in and so we just have to be cautious on how we manage that.

Contribution: I'd be interested in your views if you could look ahead five or ten years from now as to the role of ESG score providers and rating agencies because at the moment if we're honest about investment management firms they are more than capable of doing their own financial research, and the reason they are ESG research and scores off the shelf is because they're not able to do it in house because those predate ESG considerations. But in five or ten years' time when they have those ESG analysts on board, what role will the ratings agencies have then?

NB: It's an interesting question. A couple of observations. The first is, notwithstanding the very large number of banks currently operating with internal models and therefore don't require credit ratings to carry out their credential analysis there is still a very significant market for credit ratings. That's because lots of people in the market do need them and lots of people in the market use them for a variety of purposes. There may well be parts of the market that bring on their own ESG analysts and are capable of carrying out a lot of this research in house but to Peter's point at the start, many of those will look at some of the ESG providers output and lean on that, disagree with some of it, take other bits into account, and use it as a data point.

Others will simply use, whether it's the Moody's or the NCR or whatever it may be, they will use that and not bring so many people on those desks. So, I think it will totally depend on which part of the sector you look at. Some of the most sophisticated hedge funds may look at the products that are being put out by those professional players in the market and say that they can do this better/differently, and therefore we won't rely on those at all. I think a large number of people in the wider financial services sector will, provided that we are right that ESG is here to stay and isn't going to disappear in 5-10 years time, which I don't think it will.

PB: Well, there's an economy of scale here where if every firm is doing it themselves there is a cost associated with that whereas rating agencies are doing it once and then they're providing it through. And with the benefit of either a regulatory framework or a set of principles you then give that metadata that explains how things have been created you can work on the back of that. I think that for the cost of funds you want to keep the cost of ESG down and so being able to demonstrate where you got that data from and how you classify your bonds is a way of doing that cheaply. It is a good way of keeping it proportionate.

AS: One of the key benefits of what you're proposing is actually to deal with some of the greenwashing elements because by having that data and transparency you can deal with a greenwashing accusation. When a company is unfairly accused of greenwashing you actually see they are greenwashing. Is that where you would see the benefits of what you proposed, in the greenwashing space, or is that a happy coincidence.

NB: The reason that I see regulation as existing is it's there to protect against those harms that could otherwise arise in a market that is operating in an unregulated way. Regulation exists to put boundaries around the parts of the market where investment decisions are made, and people need to be able to trust the data and information they are getting. Greenwashing is part of that and means different things to different people.

In principle the risk is that if you have a market that is putting out what is supposed to be objective evaluations of ESG credentials of an issue or security and actually the product has been developed in a way that materially differs from the methodology or is using data in a questionable way, that does amount to greenwashing and is potentially going to cause harm in the market. And here harm means investors who think they are investing in a green product not investing in a green product.

AS: Last week's raid on DWS by the German authorities has been seen as a black mark on the whole industry. Can you comment a bit on that and how your recommendations would deal with those situations and solve those problems?

PB: I do believe it would solve those problems because of the accuracy of the starting point. What is happening in those organisations is that they were taking multiple data that was getting lost in a big combination with other data and then going out and tagging funds with a certain greenness. It ended up being something like 70% off the mark. It is yet to pass judgement whether that was knowingly done, but certainly the board wouldn't necessarily know whether or not that was true because if they're saying we were using external data that was telling us that this corporation has this footprint and therefore you lend/invest to them, then that's good enough. So, the whole point here is understanding the starting point and about the controls that the regulators will want to look at in an organisation that asks how you are using this data internally, what decisions are you making with it, who's accountable for it. The other point is broader than regulating ESG rating providers but it's where the thing starts.

Contribution: I want to make sure that you're not suggesting that the DWS case was because of the ESG ratings providers

PB: I wasn't suggesting that I was saying it was a combination of data that was added together

Contribution: Because the report, I think you're right in terms of how the data is used is a broader concept that this report won't only solve in terms of where it's coming from.

PB: Perhaps the regulation and management regime looks after that, but we did a review recently that there is a slight lack of ESG language in the majority of the regulations, but the inference is there.

Contribution: The work we have been doing has focused recently on one specific area of ratings and metrics- the creation and rapid proliferation of ratings on biodiversity across financial markets. Similar findings - lack of consistency and transparency, significant need for enhanced understanding of methodologies. Ratings all have different focus and different uses.

The work we've been doing is focused particularly on biodiversity. Biodiversity is something that has only attracted attention in recent years, it has really taken off and has been getting as much attention from investors as climate. This is incredible how the market has proliferated ratings, ESG ratings, sustainability ratings, in that area. We've analysed all of them and they're all completely different; there's no consistency, there's no understanding in markets of these things. I have been working with a few people in the investment industry actually trying to pull apart the methodologies of these ratings and a lot of them when you look at the ratings there's not much there or the methodology is based on something which is really not that useful.

So, it is important to have transparency in those ratings. It's fascinating and so complex to see what they are doing in these areas and what these ratings mean. Regarding regulation in the biodiversity area, it is too early to regulate because there is so much innovation and development going on, so it's too young a market for any proper regulation, but hopefully in the next few years it is something that could be implemented.

AS: Following on your comment, I completely agree I think that's a problem we have with the whole ESG thing. We talk about biodiversity; we don't know what aspect of the ESG is going to be there in five or ten years. Is there ever going to be a definitive point where we say we know what all the points of ESG are? I think probably not. Do I have to be able to add and take away different aspects of things like, also in conjunction with other government policies which may deal with some of the issues we're already dealing with. I guess then you need that sort of flexibility to take bits out, put bits in. Is that really what you're hoping to get by having all the nuts and bolts exposed?

NB: I think the important thing is the level at which you are regulating. It would be madness to suggest that there be a highly specific product-focused regulation that says that if you are doing this within this part of the E space then you have to have this methodology in this particular way. That style of regulation does not of course even exist in the credit ratings agency space. All that we are advocating is a style of regulation that says yes this is a nascent market and yes there is different methodologies people are applying, but the market will be able to make much better sense of what those ratings are if they can see the methodology that are being used and if the rating provider is required to follow that methodology in a consistent way.

Then what the market could do is that they could look at the tens or hundreds of ratings that are available to them, they can analyse the types of methodologies that are being applied and say well actually we trust these ones here because I can follow why it is that this data is being used and I can trust the output that comes. Whereas on the other side of this group of ratings I'm not behind this methodology.

PB: If you're lending say to the agriculture sector, say a bank is funding directly larger farmers or a firm, when you look at the different ESG there is a lot to contend with. You have the E around how much energy they have been using, or the fertilisers and how they are degenerating. You have biodiversity elements around fertilisers, degradation of water and soil quality, you then have labour market and its sources, an element under the S.

So, if you add all those things together, how are you going to rate that? So, I'm not sure the ESG is one thing necessarily, while I think we're advocating, it is principles-based and I hope there's scrutiny over it, the boundary of regulation, is how have you come about measuring that. I am not sure whether a farmer should be getting a green loan because biodiversity might be a red cross.

Contribution: I think what's interesting in what you set out there is the different types of risks and impacts. So, there's two lenses, it could be the runoff, or more entity specific risks and they all combine in a way that is material for that sector and that is how we would look at those combined. Biodiversity is a great example where the question is sort of underneath it is this baseload of information coming out of entities. That is the five-year piece where that will improve and that is pro-market which is what we want to see.

PB: The banks are then using, say there's been a 30% reduction in energy usage for milk and a bank has lent to that farmer. The bank is then taking that 30% reduction as a contribution to their own net zero calculations saying, "we've helped". We actually all want net zero to be successful rather than unsuccessful, but there is a huge measurement industry that is also sitting here with people counting all of their carbon offsets and therefore it all comes off the back of the data they've got and explaining to them that's what's happening.

AS: I just wondered if we were to show what data is more important, using your farming example, is there a place for where the government regulates above? Where it says actually, we focus on, this is going to be the year of biodiversity and that is going to be the #1 issue, whether that's at the government level or the international level and say the global focus on water quality and then give that direction to you guys. Is that something you would want? Because for dozens of these firms the number one priority is carbon, or slavery, or whatever and that gives them more direction because otherwise you'll have all these conflicts.

PB: Not really because I don't think one can differentiate the importance of all the ESG factors so I think it should be a combination. To use the farming analogy, government subsidies etc will trump any lending decisions and cost funding so that needs to be in harmony.

NB: I don't think your point really goes to the question around ESG ratings as much as it would go to the incentives for capital to be allocated in areas that were deeply positive in those areas of specific focus. So, you know tax efficiency, capital efficiency.

Contribution: If we look back at COP26 and transition plans coming in, it seems more important. What we actually saw at COP was huge enthusiasm for just transition and social factors, so that momentum around net zero transitions managed to align with the social factors that arguably are happening and hopefully that provides extra impetus around maybe neglected areas for companies and for us that is really interesting and important.

Contribution: I wanted to pick up on a comment, trusting the data, and I think this where there is a big problem because a lot of what we're talking about is future regulation and there is a lot of damage being done in the present which creates a lot of confusion around data, where the data is coming from, understanding what the global frameworks are and what rating agencies use and how that methodology is being displayed. I was wondering if there was a need for a Rosetta Stone of ESG where there is somewhere of clarifying what ESG is and how it relates because I spoke at a keynote talk to the GGI membership group with 70 delegates from all over the world and they are in absolute freefall around ESG because they do not know where to get the data from, how to incorporate the data, they're not trained, they don't have the skill sets and so they are looking for external rating agencies to understand what those sets mean and how we communicate that.

My concern is not just about, I definitely think there needs to be some sort of regulatory framework that's put in place because we need a starting point, like a global standard that we understand. Because something that we are starting to see is this Wild West culture, because we are seeing small agencies that are popping up overnight who are saying that we are ESG consultants, and they are going into smaller businesses delivering consultancies and reporting without using any rating agencies or global standards. There is a trust problem now. We are getting feedback from people referring to ESG being a scam, which shows there is reputational damage around ESG. I think this is a problem because ultimately it is a really good thing to have but at the moment there are issues, and I am worried about the damage being done now. That's why I think there should be some focus on a Rosetta Stone type.

AS: I think there is a reputational risk the more ESG becomes well-known, the more risk there is. If you look at the financial crash and the ratings given to those banks that went bust it damaged the reputation of the industry quite badly. Is there a danger when inevitably there will be an organisation which has been given a great ESG rating which will then damage the whole industry and put people off what we're doing? How can we make sure that doesn't happen and to look at those risks as well? How do you stop that?

NB: I suppose three observations. First, to the Rosetta Stone point there is a lot of work going on in parallel to this on taxonomy and the report we have made has to be read alongside all the work we have made on taxonomy which is incredibly important and in defining what all the terminology means and how it should be interpreted. The second point, to your wider observation that there is a benefit to having a degree of regulation, and regulation in the space we're talking about basically means principles with some teeth behind them. So, in other words some oversight by some authority that will be there to take action if people don't actually comply with the principles. That should then engender trust in the products being put out and enable people to sort between the ratings that mean something and those that mean less.

The third thing, and I think it is important for everyone to understand this, as I understand it, even in credit ratings there is subjective analysis that goes alongside the objective data points and that point has only increased in the world of ESG and E, S, and G are all very different things and where it may be possible to put objective data points on aspects of an E side of this, it is more difficult with the stuff that goes on in S and G. Even when we have that sort of greater degree of transparency and consistency around application of methodologies in this space, we shouldn't kid ourselves that that will be a set of objective data that goes out. What we are really talking about is the data points, the ratings, and so on, the things that people can trust that a proper organisation has worked through, has brought in, objectively, rational, and relevant data and used that in an appropriate way to churn out a particular score against these things.

AS: You talk about the regulation and the need to take action. What action do you think should be taken? What is a proportionate action if people break the rules? Because otherwise the rules are going to be pointless. What would be the action taken? Are we talking about fines, are we talking reputation, stripping of licences, what types of regulations and actions would you apply?

Contribution: I think it has to be reputation. I mean at the end of the day what we're looking at is reputational damage and we've seen this increasingly with people who were doing one thing within their business model while in the workplace they were doing something else. At the end of the day, it's we the consumers, how we judge and scrutinise organisations based on their performance and if you've got a ratings report that we have to trust this, and it's been done by a professional organisation and that is then seen to be.

Going back to the green claims code published last year which was written like regulation around making claims of your sustainable initiatives. So, there's already that culture of avoiding greenwashing but I think we have to expose organisations that are box-ticking and not delivering as they should be delivering. I don't think there's a way legally to police it. I think reputation is really important.

Contribution: Just a couple questions on regulations. A lot of your focus on regulations has been to do with transparency and methodology consistency. What's your view on the regulatory framework around for example conflicts of interest where ratings agencies would provide corporate advice as well as ESG ratings? Secondly, do you think regulations might edge and frustrate innovation because ESG ratings, for example a lot of the agencies like the larger ones have come at it from an ESG perspective?

NB: We touch on this point slightly in the report and I don't want to speak outside. I suppose speaking from my own perspective and the data that we have here, I think it could be quite damaging in this space to introduce the same style of regulation that exists in the credit ratings agencies that deal with the conflict-of-interest question and prevents credit ratings agencies from providing consultancy services through their rating agencies as well.

In this space, there are ESG benefits that I could see from allowing people who are experts from an ESG rating perspective to work with rating agencies to help them understand what steps they could take to improve their ESG credentials. I don't want to speak out of turn and I'm sure the people in the industry will have strong opinions about this point.

Contribution: Interestingly I think we agree there are strong policies and procedures against this. Possibly the biggest risk is that the conflict of interest impedes the ability of the agency to provide quality opinion. To answer the second question, we agree it's going to impede innovation. I think it's too strong and by its nature at this point in time of its development to cause those harms. I do think we shouldn't lose sight of the rating providers on what the solution to the underlying data problems is. We are facing exactly the same issues that investors are facing. The problem is, if you look at scope 3 missions as an example, they're non-existent. So, we have a choice either we estimate and we dispose of it with the knowledge on how we do this, or we don't do it and this does nothing.

I think this is, even where there is Scope 3 consistency disclosure it's across different categories so once you have business travel, you can't compare and contrast them. There is a huge problem with that raw data level disclosure, and you know we all know the FCN is taking steps to address that. I think that's how we get that sorted out, there will continue to be issues downstream of how that data is inserted and used. So that's what we are so strongly putting into focus to get that first level focused out. I think that would resolve a lot of the issues that we are seeing now around the quality of the data. We don't produce the data, we only use the data available, it's publicly available.

NB: Across the regulatory framework that currently exists in the UK and in the EU, there already exists the concept of identification, management, and disclosure of conflicts without the requirement for there to be a structural separation between business that could be in conflict, two different business units that could give rise to conflict. So, we have the framework that operates for most regulated firms in the UK. It's just credit rating agencies that actually have this structural divide that's in place which is possibly unique.

Contribution: Just curious about how, obviously a rating is a snapshot in time. One of the most important things to look forward to will be transition plans. If you have two companies that look the same, but one has a very robust transition plan and the other doesn't, how does transition planning lead into ratings, or does it?

PB: I'm going to sound like an echo because I was saying that one of the things we need to tackle, and that's why this report and my opinion on this is leaning towards transparency, whether that's regulated or similar, the point is there used to be some fine or loss of licence if you weren't able to demonstrate that they've actually showed the methodology of how they calculated and then consistently applied that internally as well.

Your point also about only getting publicly available data, banks throughout their relationship managers are getting non-publicly available data because they are talking to their customers and asking them extra bits of information to fill in the gaps if you'd like and then massing that together to make lending decisions and whether it's on a certain ladder of greenness for example.

So they're also talking about transition plans, and trying to factor that in but at the moment they are doing that in a very unstructured way, and again you've got a point in time that's potentially unclear using publicly available data and then you've got an assessment of a transition plan for an organisation based on the organisation's view on that and that feeds it into the lending criteria. So, you know it's structural we're leaning towards.

NB: I guess I would just say I don't think it's for regulation in this space to require or specifically address how transition planning should be taken. I think it's for the product providers to decide how they will factor transition planning into the product that they have and the weighting that they give it. That is why it's so important. Your point is in fact why it's so important for there to be that transparency about the methodologies that people are using in a sort of consistent application.

Contribution: Is it possible then that there are some structures that address sectors individually so there are expectations where in different sectors investors are looking at different criteria. Can you break that down into different industry sectors that might be different?

NB: I'd be concerned for regulation to go there at least at this stage you know it clearly in the wider financial services sector there are specific pockets of financial service provision that have far more rules about how a specific product should regulate and the characteristics of it and that has been developed normally because there has been some specific identifier of the risks of that product and consumer credit is a prime example of that where there is extremely prescriptive rules that exist because of the harm that can be created.

I mean comments made earlier about the impact of credit ratings in the financial crisis. I do not see the same risks that will exist in the ESG rating system. There's an analogy there I appreciate but I don't think they're the same. The same underlying inherent or underlying risks or harm is there in this space. I don't think the justification is there for incredibly granular regulation in this space either.

Contribution: It should be transparent. So at MSCI you can't compare a triple A full motor company with a triple A automobile plant they are completely different so what we it sector specific and we will look at what the key issues are because what causes stress to a mining company is very different to what causes stress for a software company that I think is the point. As long as it's clear investors have to go in and do their due diligence and they have to understand why it's done in a certain way and not just look at the letter grade ratings, like it's triple A and like I just said it can be completely different, so I think transparency is super important. It's important we don't have regulation that restricts the ability to be able to do that.

Investors want the ability to choose and Peter you were saying something today about credit ratings and saying oh that's all we're going to do thank you I'm going to make an investment in this space. They absolutely need to do their own due diligence in conjunction with that saying we've got x type of information, or we focus on a different area, and I think having that toolbox of measures put in in the best possible way to make the investment decision that's right for them.

AS: What can the ESG world and really ESG ratings learn from credit rating agencies? You said there were some similarities, but it wasn't comparable, do you agree with that?

Contribution: I think the word rating triggers in many people's mind a credit rating rather than an ESG rating and as such if we're beasts in a way and what's really interesting if you think about the credit rating agency is that it is such a mature market and it's just such a recognised terminology and everyone knows what it is measuring and they understand the ranking order and it absolutely needs to meet that market but that market developed over 100 years so they're in such different states and now credit rating agencies are extremely regulated but there's also lots of criticism that it is a very small market so you have to think what are the effects of very prescriptive regulations. So, we absolutely in our ESG ratings business believe that if there's a need for regulation it should just be at a very high level in principle at this stage to help the market grow in line with the report.

NB: Very briefly can I just highlight that you know the credit rating, and this is just to illustrate market forces, credit ratings are used by banks and insurers to work out how much loss absorbing capital they need to hold against the exposures that they have to different securities that they hold. So, there are critical parts of how things like credit down and losses in financial institutions and so on then get determined. ESG ratings are there to enable a transparent mechanism for people who are looking to invest in ESG positive products to make investment decisions and, one would hope over time, to encourage more investment into those companies and markets thereby improving people's ESG issues and securities and credentials. There's a very different risk profile around what these two different products are trying to achieve and that should be reflected in a very different style of regulation in the two markets.

PB: Can I build on that slightly because in the lending market what we're helping some organisations do is actually aggregate your credit ratings with your ESG ratings to work out what price you're likely at. So, the two do work together.

NB: They can be used alongside each other but they're two different things.

AS: Thank you so much for joining us, and it was great to have this discussion. I look forward to seeing everybody at the next meeting.