Submission to the Monetary Authority of Singapore's Consultation Paper P006-2023

Proposed Code of Conduct for Environmental, Social and Governance ("ESG") rating and data product providers

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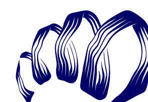

THE CREDIT RATING RESEARCH INITIATIVE

Key Issues in the Sector

There are several key issues relating to the ESG Ratings and ESG Data Services sector, many of which have been widely identified and acknowledged in other works. For a comprehensive review of some of the major issues, we point the Authority towards our submission to the UK Treasury who consulted for a similar purpose[1], and to associated academic pieces[2]. Our response to the British consultation outlined the purpose and usage of the agencies, the associated issue of oligopoly, and the concept of economic rent and its relationship to the provision of consultancy services. In order to provide use to the Authority in this submission, we scale it back and focus on the core issues of divergence, conflicts of interest, and transparency. We do this in order to shed some light on the major overarching issues that a Code of Conduct should be aiming to resolve, and which all fall in line with the issues identified by IOSCO.

Divergence

'Divergence', as it is termed, describes the disagreement amongst ESG rating agencies, sometimes on elements that can be factually proven. Perhaps the leading force in studying and articulating this phenomenon is the Aggregate Confusion Project based at MIT in the United States[3], which has produced a variety of academic outputs that explain their findings. One such output builds on the work of Chatterji et al.,[4] and argues that the correlations between the ESG ratings of six large players ranges from 0.38 to 0.71. The scholars consequently suggest that this high level of disagreement amongst agencies has several consequences, including: making it difficult to evaluate the ESG performance of companies, funds, and portfolios; companies receiving mixed signals from ESG rating agencies about which actions are valued by the marketplace; and finally that markets are less likely to price firms' ESG performance ex post.[5]

There is an argument to say that the rating of anything related to ESG is laced with difficulty, as even credit rating regulators have noted that the credit rating industry's attempts to rate ESG factors in relation to creditworthiness have also revealed high levels of divergence.[6] Nevertheless, the reality that divergence is high in the ESG rating sector could lead to systemic consequences. Min Lui makes the astute observation that divergence amongst ESG rating agencies could result in lower incentives for firms to invest in sustainable practices, given that they may not be able to signal this to the capital markets effectively.[7] As growing the concept and incorporation of the concept of sustainability is of the utmost concern for almost every marketplace, the potential impediment that inefficiency in the ESG rating space creates is significant.

However, there are ways in which this can be resolved. Whilst financial information is usually quantitative-based and therefore has a higher

degree of convergence amongst the ratings of such information (in the credit rating sector), ESG-related information tends to be qualitative-based which inherently is more subjective. To alleviate this problem, scholars have suggested that more quantitative data in the ESG informational flow could be helpful. ESG rating agencies have a part to play in this too, as some retain the process of actively engaging with companies to receive the necessary data for ESG ratings. Those that do retain this practice should work on quantifying the data they receive (in the way they ask for it) as much as they can. Where an ESG rating agency relies on publicly-available information, then it quickly becomes the case that they are dependent upon the quality of the disclosure processes in place within a given jurisdiction, and the form that information takes (qualitative, quantitative, or a blend of both). For regulators, this is why a systemic understanding is required because there are certain things that ESG rating agencies can do, and certain things they need organisational assistance with, with data and its format being key in that regard.

Conflicts of Interest

There are a variety of conflicts of interest that are blighting the ESG rating space, with many being similar or even identical to those negatively affecting the credit rating space. It is not surprising to learn this, given both the similarity in their offerings and also the cross-pollination between the two interconnected industries. Yet, the nuanced reality of the ESG rating space provides for a framework within which we can understand the different conflicts of interest better.

One example of this nuanced reality in relation to conflicts of interest can be found in an understanding of the remuneration models employed by the majority of the ESG rating agencies. Almost all of the ESG rating agencies employ an 'investor-pays' model of remuneration, as opposed to the 'issuer-pays' model employed by the credit rating agencies. This, on the face of it at least, removes a number of conflicts of interest, like the obvious one that comes from selling consultancy services to the same company one is rating.[8] This conflict does reveal itself in the investor-pays model, but not to the same extent. Conversely, there is actually an argument that selling such services to investors is of critical importance, as it helps the investors successfully onboard the sometimes complex and subjective ESG ratings.

Another conflict that has real potential to cause negative effects for the ESG rating industry is borne from the convergence between the credit and ESG rating industries, as the more resource-rich credit rating agencies continue to muscle their way into the space. Scholars have found evidence that shows newly-acquired ESG rating entities tend to inflate the ratings of key companies that their new parents rely upon for business.[9] This finding has been found by others too.[10] If the first two potential conflicts of interest – remuneration and ownership – are familiar problems then the third is less traditional, but no less important. As

discussed by Dell'Erba et al., 'the third major problem might be the "Arthur Andersen"-like problem. Beyond traditional issues of investor protection and, under specific contexts, a crucial risk of ESG gatekeepers' conflicts of interest is the possibility of favouring greenwashing practices, instead of contributing to the shift towards sustainability'.[11] There is a related issue here to the world of credit ratings. In the aftermath of the Financial Crisis, which all centred around toxic assets in the residential mortgage sector that the credit rating agencies did not investigate properly nor apply the appropriate due diligence processes to, their response upon investigation was that it is not their job to look for fraud in underlying assets. It is not unthinkable that an ESG rating agency would have the same response if it came to pass that the aspects they were considering in their rating had been greenwashed by the company i.e. 'that's not our job'. If we accept this, then the role of ESG rating agencies within the broader financial architecture aimed at increasing sustainability practices needs to be thoroughly considered and articulated.

Transparency

Transparency is often the primary aim of any rating-based regulatory agenda, for a variety of reasons. Opaqueness is often quoted as being the biggest barrier to the successful incorporation of the products of the agencies, and in increasing transparency there exists the solution to many of the problems that may plague a rating industry. This was the case after the Financial Crisis, when regulators around the world pushed credit rating agencies to publicly disclose their methodologies. At the moment, in the ESG rating space, only about half of the leading players publicly disclose their full methodologies, with many choosing to either publish brief overviews or publish nothing at all. However, transparency has its natural limits which much be respected.

One of the issues that can affect the objective of achieving methodological transparency is that the methodology and its application are only components of a longer rating process. For example, an analyst may diligently apply a methodology that has been publicly disseminated, but that analyst must then take their deliberations into a 'rating committee', that is always behind closed doors and is opaque by necessity. In the credit rating realm the rating committee has been left entirely untouched by regulation, and there is no indication from around the globe that things will be any different in the ESG rating realm. This is because enforcing the publicisation of a methodology is at the very edges of what is deemed acceptable, regulatorily speaking, because going any further would strip a critical component of the rating universe from the agencies: perceived independence. A rating agency can only exist because it seeks to provide an independent and third-party perspective on the worthiness of a given metric, whether creditworthiness or in relation to ESG-related metric. Therefore, there is a natural limitation to the regulatory agenda of transparency.

A Focus on Second-Party Opinions (SPOs)

Second-party opinions (SPOs) are reports provided by specialised agencies to assess the likely compliance of an ESG product to a given international framework. Typically, they are used to provide confidence to interested parties on a financial product's alignment with up-to-date ESG market practices. For example, when a firm wishes to issue a new green bond, they might use an SPO to signal credibility that the bond adheres to ESG standards, without actually having a formal ESG rating. Despite the benefits they can provide, SPOs have also birthed a range of issues, primarily regarding their lack of a formal regulatory framework.

First, SPOs are independent, unregulated assessments that are not subjected to a regulatory framework as would normally be the case with other ratings. In a novel space where regulations drive ESG-product ratings, it is important that SPOs play by the same rules. Considering they were once created as a supplement to regulated ratings, SPOs have slowly become a surrogate to an official rating entirely. The effect of this that a product that is 'increasingly' being demanded by investors is both operating in an unchecked area of the financial services arena, but also the usage of the products is also being left unchecked.

Second, SPOs are often provided by those same rating agencies that also conduct regulated ESG credit ratings themselves—S&P, Fitch, MSCI. While these agencies clearly have the expertise to conduct such assessments, such a dual role has the risk of embedding a conflict of interest. It could potentially be the case that a formal rating agency is providing such unregulated assessments - for a fee - alongside regulated assessments, or even in place of regulated assessments. Additionally, the purchasing of an SPO could be used as a method to encourage further business relationships.

Third, the regulations themselves are fluid and can differ widely internationally. While SPOs can give an assessment of compliance with certain countries' regulations, it would be quite feasible to cherry-pick specific countries' regulations for such an assessment. In a space that already has weak consistency in guidelines, such an additional risk could be material.

Unless country regulations include SPOs, we would expect a significant risk of a parallel market developing in SPOs vs formal ESG ratings. Issuers could potentially 'shop around' for better SPOs - perhaps paying a higher price for a better rating - and clearly running a potential credibility risk for the entire market. In such a nascent market as ESG ratings, already at risk of standards confusion, such an additional risk would be material. Well-developed regulatory environments would be well placed to ensure the Code of Conduct route encompasses SPOs to head off this genuine risk.

However, it is difficult to determine whether a Code of Conduct would be the appropriate vehicle for regulating something as complex, widespread, and potentially influential as SPOs. It is for this reason that we conclude, below, that a Code of Conduct should be seen as the first stage in a regulatory journey that cumulates in formal regulation. It is at this point that regulating SPOs would become appropriate.

Regulatory Options

In answering the call from IOSCO to take some sort of regulatory action with regards to the ESG rating space, a jurisdiction is faced with two options: either formally legislate for the ESG rating space, or instead build a Code of Conduct that ESG rating agencies should follow. Taking such a soft-law approach can be hardened by a Comply-or-Explain infrastructure, but that is just one of a variety of ways the Code of Conduct can be enforced. In this section, we take a brief journey through the major regulatory efforts that have been conducted so far.

Japan's Code of Conduct

The Code of Conduct developed by the Japanese Financial Services Authority was established at the end of 2022.[12] It aims to meet the call from IOSCO and sets about providing for base standards in a variety of areas affecting ESG rating practice. Based on six (6) principles, the Code of Conduct positions that:

1. ESG evaluation and data providers should strive to ensure the quality of ESG evaluation and data they provide. The basic procedures for this purpose should be established.
2. ESG evaluation and data providers should secure necessary professional human resources to ensure the quality of the evaluation and data provision services they provide, and should develop their own professional skills.
3. ESG evaluation and data providers should establish effective policies so that they can independently make decisions and appropriately address conflicts of interest that may arise from their organization and ownership, business, investment and funding, and compensation for their officers and employees, etc. With regard to conflicts of interest, providers should identify their own activities and situations that could undermine the independence, objectivity, and neutrality of their business, and avoid potential conflicts of interest or appropriately manage and reduce the risk of conflict of interest.
4. ESG evaluation and data providers should recognize that ensuring transparency is an essential and prioritized issue, and publicly clarify their basic approach in providing services, such as the purpose and basic methodology of evaluations. Methodologies and processes for formulating services should be sufficiently disclosed.

5. ESG evaluation and data providers should establish policies and procedures to appropriately protect non-public information obtained in the course of business.
6. ESG evaluation and data providers should devise and improve the way they gather information from companies so that the process becomes efficient for both service providers and companies or necessary information can be sufficiently obtained. When important or reasonable issues related to information source are raised by companies subject to evaluation, ESG evaluation and data providers should appropriately respond to the issues.

India's Regulation

Conversely, the Indian regulator SEBI decided to take a different route, and instead updated their credit rating regulations to now include ESG rating agencies. In July 2023, the regulator notified the markets that ESG rating providers would need to register with the regulator, and that there would be various requirements that prospective providers would have to comply with. For example, there would be a minimum number of specialised employees that an agency must have to be considered an ESG rating agency, and also it was confirmed that an ESG rating agency must make its methodology public. Furthermore, ESG rating agencies are not allowed to hold more than 10% of the stock of another ESG rating agency. In terms of equivalence, foreign providers seeking to do business in India must have at least five years' worth of experience and be registered to a comparable regulatory programme in their home jurisdiction.

Proposed European Regulation

In June 2023, the European Commission released its take on the IOSCO call. It presented a proposed Regulation, which in the European Union constitutes a hard-law mechanism. In the proposal, base standards were put forward relating to aspects such as analyst training, methodological transparency (full publication) and other elements. To accommodate the new regulatory approach, the European Securities and Markets Authority (ESMA) was given full authority to supervise the sector and build a full registration programme for prospective ESG rating agencies, with similar equivalence measures as had been applied in India.

The majority of the proposed Regulation was uncontroversial, bar one particular Article. In the Regulation, there is a direct prohibition on consultancy services, also known as ancillary services. This decision put the Commission at odds with anywhere else in relation to ESG rating regulation, and at odds with the entire history of credit rating regulation. However, despite the clear objective of reducing conflicts of interest, it is widely considered that this approach may not survive to the full

Regulation, as users of ESG rating agencies have already complained about the prospective prohibition and the effect it will have on an investor's ability to understand and incorporate the ESG rating into the investment decision processes efficiently.

Draft UK Code of Conduct

In the UK, the Treasury held a consultation regarding whether there is a need for an Act of Parliament to bring the ESG rating agencies under direct regulatory control. In the meantime, the decision was taken that a select group would build a Code of Conduct that would bridge the gap in the UK between now and when the Treasury takes its final decision. The draft form of the Code of Conduct, which is where the UK is up to at the time of writing ahead of the deadline for this consultation, looks almost identical to Japan's Code of Conduct developed by the Financial Services Authority. However, there are some slight differences in the constitution of the principles put forward.

Whilst the first two principles of good governance and maintaining written policies are similar, the request in the third principle to adopt policies so that the ESG rating agency remains independent and free from 'political or economic interference' is interesting.[13] One may wonder whether this is in relation to the predominantly Anglo-American focus on the so-called 'culture wars' and the role that the concept of ESG plays within that spectrum. In every other aspect though, the Code of Conduct is similar if not identical to Japan's Code.

Recommendations

Overall, we suggest that a Code of Conduct within Singapore is, at the moment at least, an appropriate vehicle for overseeing the development of the ESG rating space. This is because Singapore can utilise the time that the Code of Conduct provides to build a more substantial, and eventually necessary formal regulatory framework for the governance of ESG rating agencies and data providers. Codes of Conduct are not, ultimately, appropriate for the rating spaces given their centralised importance to the movement of capital. As ESG rating agencies become more important to the movement of ESG/sustainability-focused capital around the globe, a jurisdiction could easily find itself vulnerable to the global financial architecture if it has not regulated efficiently and, in the best-case scenario, proactively. We therefore call on the Monetary Authority of Singapore to utilise the space and time that a successful Code of Conduct can provide to a regulator to put the pieces in place for formal regulation.

Responses to Consultation Questions

There are only some of the questions posed at the end of the consultation that can be appropriately answered here, by us, in this report. Some questions are better suited to ESG rating agencies themselves, and others to market participants. However, with that being said, we submit the following in response to the following questions:

2. We provide our answer in the report above. However, for clarity, we believe that SPOs should be scoped as ESG products under the Code of Conduct for the reasons we give in the dedicated section above.

6. The Comply-or-Explain is a traditional and well-versed method of enforcing a Code of Conduct in this manner. Our advice to the authority is to make it publicly clear the processes for failing to comply, the relevant stages to development, and the eventual penalties for non-compliance (if any).

8. In answer to the question on assurance, we suggest that regulators around the world, include MAS, take great care when delving into the concept of assurance relating to ESG. This is because assurance needs to be solidified component of a much larger infrastructure with a clear rationale underpinning all strategic decisions. For example, whether full or partial-assurance is acceptable is a delicate decision to be taken. Also, the role of third-party assurance providers would then need to be considered from a regulatory point of view, with it arguably being inappropriate to provide a Code of Conduct for that sector, meaning substantial regulatory resources may need to be deployed to set up an effective infrastructure to achieve adequate levels of assurance for the informational flow.

10. The eventual plan to incorporate ESG rating agencies into the CMS licensing regime and equate their regulation to that of credit rating agencies is a wise and almost necessary one. A Code of Conduct, in this field, is unfortunately nothing more than a bridging mechanism between a standing start and full regulation. This is simply because of the extraordinary potential that the ESG rating space has in terms of ESG financing facilitation. If, as expected, the marketplace oligopolises and becomes the facilitator the capital markets are waiting for, then a Code of Conduct will cease to be even vaguely appropriate and a full and extensive regulatory framework, complete with a genuine consideration of liability exposure and implementation, will need to be put together.

11. Like other jurisdictions, the question of equivalence is an important one. However, the early stage of progress for the ESG rating space means that equivalence is a difficult objective to achieve as only one country so far has formally regulated and, even then, India's regime is very particular to India. Seeking equivalence based on Codes of Conduct

is not appropriate. Therefore, Singapore must decide whether requesting for a presence in her jurisdiction, which foreign providers can accomplish through the simple act of subsidiarisation, both a. provides enough authority for the likes of MAS to govern foreign ESG rating entities, but simultaneously b. does not deter foreign business from conducting business in Singapore. That is a political question perhaps, but we do believe that a registration system that incorporates the potential for foreign subsidiaries located in Singapore to do business could be appropriate.

12. Whilst question 12 may be better suited to market participants to answer, we would like to say that there should not be too much time between the establishment of a Code of Conduct and a full regulatory regime. This is because Singapore must ensure that she is well protected from the inherent issues affecting the ESG rating space (which a Code of Conduct does not really achieve). However, it is likely too early in the ESG rating space's development to fully regulate, so the middle ground could be after, say, 12 months of the Code of Conduct and after 12-18 months of consultation for a full regulatory regime. In this time, the marketplace will likely have changed considerably and present a more opportunistic moment to fully regulate.

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