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UK Updates Its Green Finance Strategy and Launches ESG Ratings Regulation Consultation

April 4, 2023

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On March 30, 2023, the UK government **announced** the publication of its **2023 green finance strategy**, updating its earlier 2019 strategy, which is intended to mitigate climate-related risk and damage while increasing the amount of capital available to finance "net zero and environmental objectives." Additionally, the government published a **nature markets framework**, which has been developed to scale up private investment in nature recovery and sustainable farming. The executive summary of the framework states that the "development of high-integrity nature markets is a key part of [the UK government's] strategy to enable firms to mobilise" private investment flows to nature.

As part of its updated strategy, the UK government has **launched a consultation** on the scope of a future regulatory regime for ESG ratings providers. Interested parties have until June 30 to submit their responses to the Financial Conduct Authority. The consultation states that "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." In terms of its planned regulatory approach, the Consultation states that the "FCA has indicated that, subject to consultation, they anticipate their regulatory approach would take the main elements of IOSCO's recommendations as a starting point for rules," but would not "seek to harmonise the varying methodologies and objectives of ESG ratings as a regulatory outcome." The recommendations of IOSCO, the International Organization of Securities Commissioners, focus on transparency of methodologies and data sources, good governance, conflict of interest management, and the existence (or lack) of "robust systems and controls."

The government is currently proposing an extensive list of exceptions to coverage under the proposed regulation, which have been set out in the consultation document. For example, unprocessed, or “minimally processed,” data that does not have an assessment element is not in scope. Also proposed to be excluded are credit ratings even if they consider ESG factors (which already are subject to regulation under the Credit Ratings Agencies Regulation), investment research even if it references ESG considerations, and proxy advisory services recommendations, which, “even if related to ESG matters, are provided for a specific purpose (informing shareholders) and therefore should not be subject to the same regulation as ESG ratings.” In terms of geographic coverage, “Treasury proposes to capture, at a minimum, the direct provision of ESG ratings to users in the UK, by both UK firms and overseas firms. This includes direct provision to both institutional and retail users in the UK. This would not capture the provision of ESG ratings by any UK or overseas firm to any user outside the UK.” Recognizing the potential for conflicting ESG ratings regimes among different jurisdictions, the Consultation states that “if other jurisdictions introduce similar regulation to that which would be present in the UK, and where there are suitable cooperation mechanisms, HM Treasury will consider whether to expand its deference framework to provide for the recognition of equivalent overseas regimes.”

In announcing the updated strategy, the UK’s financial regulators issued a **joint statement** that they “are now actively supervising and holding organisations within [their] regulatory perimeter (both real economy and financial services) to account on climate-related matters.” The statement highlights greenwashing as an example of a “real risk to the transition, to market integrity and to investors.” Nikhil Rathi, Chief Executive Officer of the Financial Conduct Authority said: “We welcome this updated Green Finance Strategy, which represents an important milestone, building on collective efforts to date and setting out a clear plan for the future. We are working hard to ensure that the UK market is well positioned to support the transition to net zero. We’re playing our part in delivering a world-leading framework for transition plan disclosures through our collaboration with the UK Transition Plan Taskforce.”

Taking the Temperature: The UK government’s announcement of an update to its green finance strategy follows several recent developments from UK regulators, including the classification of nuclear power as environmentally sustainable, the Bank of England’s updated assessment of climate-related risks and the regulatory capital framework for financial institutions, and the UK Pensions Regulator’s announcement of the launch of a new initiative aimed at tightening regulation around ESG data published by trustees, as part of a wider campaign to assess whether trustees are properly discharging their ESG and climate change reporting duties. The focus of the updated green finance strategy on attracting capital is consistent with a recent statement by the Green Technical Advisory Group, an independent advisor to the UK government, in a recent paper arguing that the UK must “significantly raise its own game” on net-zero to avoid losing out to international competitors, as “the race to attract global capital to support green industry and market development is well and truly on again.”

The proposal to regulate ESG ratings is notable. As we have previously discussed, there is significant uncertainty in the ESG ratings market resulting from a variety of issues. First, ESG ratings providers use different ranking methodologies that can lead to divergent rankings for the same company. ESG ratings providers use a variety of sources of data, methodologies, and formulae to arrive at their ultimate ESG scores.

They present their data using different scales—some using letter rankings with others providing numerical scores—causing difficulty when trying to perform one-to-one comparisons between ESG ratings providers. Some ratings providers rely solely on publicly available information as their source data, whereas others rely on questionnaires and feedback from companies directly, which may include material information not otherwise available to the public, in addition to information that is publicly available. Second, lumping all of "E" and "S" together—or, at times, all of the different issues within each of these categories—can obscure the reason for a particular company's ESG rating. The at times low correlation among ranking scores, the lack of granular information as to the basis of the rating, and, more generally, concerns around the transparency of ratings processes have led some to question the value, or how to best make use, of ESG ratings. Third, most ratings do not assess companies' sustainability profiles, but instead are based on the impact of climate change on a company's anticipated financial performance: If an ESG ratings provider concludes that climate change neither poses a risk nor offers opportunities to the company's bottom line, it may issue a higher ESG rating that is not necessarily reflective of that company's sustainability efforts.

In light of these issues, it is not surprising that the concept of ESG ratings regulation is not limited to the UK. Regulators or legislators in India, the U.S., the EU and elsewhere likewise are considering the issue.