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ESG RATINGS - SPIN ON A TURNING WICKET

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In what could be perceived as an overdrive, SEBI has issued several consultation papers in the last one month. We have attempted our take on two of them.

In the last few years, global leaders (with one exception who could not distinguish between climate and weather) have been concerned about the impact that global warming would have on climatic conditions, as also on corporate entities that create wealth. Somewhere along the way, the focus on ESG seems to have reduced other major concerns and problems to relative insignificance. One is reminded of the saying that a pair of very tight shoes serves a purpose because every other pain or problem tends to get ignored.

Post the Russia Ukraine imbroglio, the relentless thrust towards higher environment standards, and the promotion of sustainability, has taken a step back, with the high priests of the ESG movement themselves having to opt for fossil fuel, to meet their energy requirements. The claim that ESG is a cure-all, or a magic wand, has been debunked by academics as well as some corporate leaders. The global guru of valuation has gone as far as to say that ESG based investment decisions will lead to suboptimal returns.

There is one community that is pressing on regardless. Regulators worldwide are reportedly concerned that climate change is the big issue that corporates have to address. Some are going ahead with regulatory interventions at a measured absorbable pragmatic pace, while some others seem to be in a hurry to conquer unexplored territories. Nearer home, SEBI has got into a consultative overdrive, with a number of consultation papers on various aspects of ESG. We have attempted our take on two of them, Consultation Paper on ESG Disclosures, Ratings and Investing (Paper 1) and Consultation Paper on Regulatory Framework for ESG Rating Providers in Securities Market (Paper 2).

The detailed requirements spelt out in both the consultation papers would well give rise to a concern whether control is being passed off as regulation, with micromanagement not being shied away from. This comes even as there is clear recognition that jurisdictions elsewhere have opted for voluntary frameworks, with some element of “comply or explain” built therein (India’s only experiment with “comply or explain” was short lived, with performance under CSR now being closely monitored and regulated by the Ministry).

It is useful to start with the latest regulatory framework for ESG Rating Providers (ERPs), to understand why SEBI is embarked on these activities. Paragraph 7 of Paper 2 states that "while Regulators in certain jurisdictions have opted for a voluntary code of conduct for ERPs, SEBI proposes an enforceable regulatory and supervisory framework for ERPs". The one sentence paragraph, which is somewhat convoluted, speaks of SEBI's experience of regulating Credit Rating Agencies (CRAs) in 1999, well before the global financial crisis. It cannot be anyone's case that the 1999 regulations ensured subsequent good conduct by all rating agencies across India. The approach is somewhat ambivalent, considering that in the very next paragraph, of the same consultation paper, it is stated that "given the nascent nature of the ERPs, and to provide for scope for further innovation, SEBI has attempted to follow a principles-based approach, while balancing SEBI's mandate of protection of interests of investors". Elsewhere in the consultation paper, there is a reference to the need for encouraging newer ERPs and start-ups in this line of business.

At this juncture, it is useful to ask a basic question – "What category of investors is SEBI seeking to protect?" In a significant judgement (Berubari case 4), while interpreting the Constitution of India, the Supreme Court had observed that the Preamble to the Constitution is a key to open the minds of the makers of the Constitution. Applying the same principle, it is useful to look at the Preamble to the SEBI Act to determine why SEBI exists. The Preamble has 3 elements – regulating the market, development of the market, and the protection of the interests of the investors. One way of interpreting this is to look at regulation and development as means to an end, which is the protection of the interests of the investors. Clearly the makers of the SEBI Act did not have, in their minds, large savvy institutional investors as their primary constituents, that needed protection. Therefore, to conclude that there should be a highly prescriptive regulatory regime for ERPs is difficult to comprehend, since large institutional investors are the major users of these indices. One is reminded of the ill-advised and stillborn attempt in the USA, some years ago, to provide protection to hedge fund investors, who made it abundantly clear that they were capable of looking after themselves.

Some specific aspects of the proposal need to be focused on:

While detailing the requirements of registration as an ERP in Paper 2, an attempt has been made to capture therein some elements of regulations relating to CRAs, and some elements of regulations applicable to research analysts (in particular, Proxy Advisory Firms). Borrowing from both these sources, and attempting to weave a regulatory pattern, is neither desirable nor necessary. If ERPs are to be subjected to entry level stipulations that exist for other service providers, the overload could be crippling. Much the better alternative is to write a simpler set of entry level regulations, applicable only to this category, recognising that ERPs and CRAs are nowhere near providers of similar services.

In the same paper, ERPs are proposed to be divided into 2 categories, with lesser requirements for category 2 entities. The attendant conditions go as far to state that they are not required to have an office, if they practice work-from-home. Also, there are interesting stipulations, such as the kind of persons that need to be engaged by such ERPs. One of the requirements is that there should be at least 5 employees, specialised in the following areas, at all points, with at least one specialist in each of the following areas – governance, sustainability, social impact or social responsibility and data analytics. Why 5 persons should be required, when 4 areas have been identified, is a minor point. Governance and data analytics lend themselves to specialisation. How someone can be described as a specialist in social responsibility is not easy to fathom. As for sustainability, this is more a buzz word than a specialisation. What really makes a person a specialist in sustainability? Is it the ability to plan and implement a long term strategy, or the ability to put in place survival tactics, that do not extinguish the corporate within a reasonable timeframe? The concern cannot be wished away that some of these aspects have been left vague, leaving room for interpretation.

Yet another requirement is that the applicant should have "professional competence, financial soundness and general reputation of fairness and integrity in business transactions, to the satisfaction of the Board" (SEBI). Having stated this, it goes on to state that the applicant, and its promoters, must be "a fit and proper person, as per Schedule II of the SEBI (Intermediaries) Regulations, 2008". It is reasonable to presume that either one of these two stipulations would have sufficed. Prospective applicants may be pardoned if they wondered which of the two would hit them harder, climate change or the ESG Regulations.

In Paper 1, it is useful to take note of paragraph 2.3, which states in clear terms that there is a need for ERPs to factor in a local/ domestic context, while assigning ESG Ratings. To address the important requirement of contextualisation, SEBI had set up an Advisory Committee, the recommendations of which are stated to have been captured in the consultation paper. Staying with this theme, SEBI has pointed to the need to recognise continuing improvement, rather than to take stock of the present position companies are in, and to pronounce judgement thereon. This would mean that if a corporate had not done anything of note in the previous years, and had made some progress in the year under review, it would have to be favourably judged, much like the most improved student in the classroom, rather than the best student. Whether such an approach is preferable, with the overarching concern that has been expressed in different fora, of getting everything right very soon, is a matter that merits some thought.

In Paper 2, it is stated that one of the terms of reference of the Advisory Committee was “developing uniform indicators of G, as input to ESG ratings, and/or credit ratings”. The problem with uniform indicators is that they remain static, whereas, in pursuit of higher governance standards, there should be higher expectations from the providers. Uniformity is desirable, but it should not get in the way of continuous upgradation of parameters. It must be recognised that so long as compliance parameters are used, sooner or later, every company will measure up to expectations, and there will be no governance-based differentiator among companies.

The terms of reference of the Advisory Committee also provided for “developing separate/ parallel approach for ESG rating suitable to emerging markets e.g. focus on ‘S’ including employment generation, etc.”. S is one of the 3 critical pillars of ESG. It should not be seen through the lens of employment generation alone. The S pillar owes its place to the recognition that society is an important stakeholder, and therefore while contextualising the approach for rating to Indian conditions, no significant aspect should be lost sight of.

One major positive is the recommendation in Paper 1 that Asset Management Companies (AMCs) maybe permitted to launch “one ESG scheme each” under 5 different ESG sub-categories. This is a welcome departure from the unduly prescriptive provision which now exists that only one ESG scheme can be launched by a mutual fund under the thematic category of equity schemes.

SEBI has recommended, in Paper 2, that ESG Rating providers who wish to operate in the Indian securities market, should form an industry association, and play an active role in development of a regulatory framework for ERPs. Based on the Association of Mutual Funds in India’s (AMFI’s) experience, it must be noted that there are big entities and small entities, which together make up the membership of the association. The smaller entities are known to have expressed the concern that the problems of the bigger entities alone get more airtime at AMFI meetings. The proposed industry association of ERPs, might end up as a forum where the concerns of the big boys alone get addressed.

While companies have barely got to grips with complying with the Business Responsibility and Sustainability Reporting (BRSR) requirements, a concept of “BRSR core” has been introduced in Paper 1. Ordinarily, one would have expected that the BRSR core would be a carve out of the more important elements from the BRSR. However, the BRSR core, as proposed, contains aspects which are not a part of the BRSR, or any current form of disclosures. It is reasonable to presume that companies which have put in place the requirements for complying with BRSR, will immediately have to adjust to comply with newer requirements being thrown up by BRSR core. Others would find it difficult to do so. Further, while the consultation paper rightly states that pushing some factors from leadership indicators to essential indicators should be done in the future, elsewhere in the paper, there is an attempt to push one/ more leadership factor(s) to essential factor(s).

The differentiation between core and non-core BRSR in the context of ESG Ratings is that while the former (core ESG ratings) is based on assured or verified data, the non-core element may comprise an additional commentary/outlook/observation, that may be on data that may not be verified/ assured. By way of example, it has been indicated that while an unverified controversy must not be factored in the core ESG rating/ score, ERPs shall have discretion to provide a commentary on the same, if they so desire. Proceeding on unverified / unassured data is the equivalent of getting into dangerous territory. Subjectivity, especially rumours, should not be allowed to find its way into an ESG rating or score, even if it is described as additional commentary.

The articulation of the ESG rating rationale in detail has been indicated to be essential so as to enable a stakeholder to assess the reasons behind an assigned ESG rating. This is further necessitated by the divergence in ESG ratings across providers. The objective should be to considerably reduce, if not eliminate, such divergence in ratings. The publication of a detailed methodology document, and making it available to stakeholders, should by itself reduce asymmetry, since the relatively lighter elements will get identified and given lesser value.

Paper 1 focusses on the importance of “Assurance”, as one of the measures to prevent the ills of greenwashing. While this is a laudable objective, it does raise the question whether the number of service providers are adequate, and have the relevant expertise, to provide such assurances over the next 3 years.

The overarching philosophy seems to be to have a system that captures the Indian ethos and makes the offering contextually relevant. In this background, the need for factoring in Purchasing Par Parity (PPP) is not clear.

There is one element that should not be lost sight of. These important consultation papers do not provide enough time, or a detailed study, for absorption of its key elements, framing one's thoughts, and sending them in the prescribed format. Timelines, which in earlier cases were in excess of one month, have shrunk to 10-15 days in some cases. If consultation is to be meaningful and effective, the process should not be rushed.

Briefly going back to the Preamble to the SEBI Act, there is a need to reiterate that the development of the market is one of the stated objectives. This seems to be lost sight of in most conversations. Development of the market is an instrument to provide for orderly conduct in the market, leading to the protection of the interests of the small shareholders. Development implies more products, from plain vanilla products to complex products, resulting from mathematical modelling. It also recognises the need for more investors, with different levels of sophistication. In this environment, it seems counterproductive to put in place restrictions and obstacles, that will prevent, or at least discourage, newcomers from coming into this space of index providers or ERPs. Indian players, without baggage, are very well positioned to understand ground realities, and to contextualise their offerings. Regulatory philosophy should not stand in the way of adding these providers to the existing miniscule number.

Whatever happened to the need for promoting the ease of doing business?

Tailpiece: In a separate Consultation Paper on Strengthening Corporate Governance at Listed Entities by Empowering Shareholders – Amendment to the SEBI (LODR) Regulations, 2015, attempts have been made to make life more difficult for promoters, who have invested time, money, effort and reputation, in setting up and carrying on business. Financial regulations would do well to build in an element of trust in those who have actually set up businesses.

There has been no shortage of comments on the Adani saga. For our views, please click here