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Dear CEO,

ESG Benchmarks Review

In September 2022, we sent a portfolio letter to benchmark administrators outlining our supervisory priorities and view of the risks within the sector. One of our observations was that the subjective nature of ESG factors and how ESG data and ratings are incorporated into benchmark methodologies could increase the risk of poor disclosures. We expressed our concern that the quality of benchmarks may not align with the expectations of users and end investors. We also said that this might impact trust in the market for ESG-labelled products and the transition to a net zero economy.

Since publishing the portfolio letter, we have completed a preliminary review on ESG benchmarks. This work assessed the quality of disclosures made by a sample of UK benchmark administrators. In general, this was poor. There were often instances where benchmark administrators did not provide sufficient detail and description of the ESG factors considered in their benchmark methodologies. Some firms had failed to fully implement the disclosure requirements introduced in the Low Carbon Benchmarks Regulation (UK version of Commission Delegated Regulation (EU) 2019/2089). We also evaluated the robustness and reliability of ESG benchmarks. We saw examples where benchmark administrators had failed to implement their ESG benchmarks' methodologies correctly.

ESG matters are high on our regulatory agenda. The FCA published its ESG strategy in November 2021. For the financial sector to help support the transition to a more sustainable future, market participants and financial services firms need high-quality information, a well-functioning ecosystem, and clear standards. As part of this strategy, we proposed new rules to tackle greenwashing. Whilst these are primarily focused on investment products, the proposals contain an anti-greenwashing rule which reiterates requirements that all regulated firms making sustainability-related claims must ensure these are clear, fair and not misleading. If brought into force, this rule would apply to benchmark administrators alongside your obligations under the UK Benchmarks Regulation (UK BMR). You should consider this in your benchmark naming, disclosures, and other supporting documentation, including marketing materials.

Attached to this letter, we set out our assessment of the risks observed and the issues identified based on our preliminary review. We expect you, your senior leadership, and your Board to carefully consider the messages we have set out as they pertain to your business. You should ensure that you have appropriate strategies to address them, and you should be prepared to explain these strategies at our request.

Next Steps

Given the importance of ESG benchmarks and our initial supervisory findings, which indicate the potential for widespread failings, we will be doing more work in this area across the portfolio. We will holistically consider the risks of harm related to ESG benchmarks across the value chain.

Where firms fail to consider our feedback, we will deploy our formal supervisory tools and, where appropriate, consider enforcement action in line with the FCA's Approach to Enforcement.

Yours faithfully

Jon Relleen
Director of Infrastructure & Exchanges
Financial Conduct Authority

Risks observed and issues identified

Benchmark Statements

Administrators must publish a benchmark statement for each benchmark, or where applicable, for each family of benchmarks that may be used in the UK. These statements should contain essential information to enable users to understand what a benchmark measures, its risks and ultimately allow users of benchmarks to make informed decisions when selecting a benchmark.

In our review, we noted that some descriptions of the market or economic reality measured by benchmarks were generic, particularly in benchmark statements for families that covered a broad range of benchmarks. Whilst additional information was often made publicly available in other documents, such as the methodology, we expect administrators to consider whether links to such materials are clearly sign-posted and easily accessible to users.

All benchmark administrators in our sample failed to provide sufficient explanations in their benchmark statements on how ESG factors are reflected against each of the requirements referred to in paragraph 2 of Article 27 of the UK BMR. For example, no benchmark administrator referred to ESG factors in their explanations of the rationale for adopting the benchmark methodology. We remind firms that this requirement is in addition to providing the ESG disclosures for benchmark statements using the template contained in the UK version of Commission Delegated Regulation (EU) 2020/1816.

Benchmark Methodologies

Benchmark administrators have significant discretion when designing their benchmark methodologies, including deciding which ESG factors will be considered and how these are applied in the methodology. For this reason, it is important benchmark administrators provide good-quality disclosures so that users and end investors can assess the benchmark's ESG claims. Benchmark administrators must provide specific information on how key elements of the methodology reflect ESG factors for each benchmark or family of benchmarks, considering the underlying assets on which the benchmark is based. The minimum content of these explanations is set out in the UK version of Commission Delegated Regulation (EU) 2020/1817.

In our review, we found a lack of detail in benchmark methodologies. For example, there was little explanation on the ESG factors used in benchmarks and the thresholds benchmark administrators choose to apply when measuring these. We are concerned that this can contribute towards or lead to greenwashing. This is particularly concerning where benchmarks that purport to pursue ESG objectives apply ESG factors in such a way that the constituents are not materially different to a similar non-ESG benchmark.

In some instances, benchmark methodologies did not clearly describe why certain ESG factors were applied. For example, where a benchmark purports to have climate objectives only, but uses broader ESG metrics in its methodology, the benchmark administrator should clearly explain why the broader ESG metrics are appropriate, given that they also factor in social and governance factors.

The FCA included a discussion chapter on ESG integration in UK capital markets in CP21/18. In our feedback statement (FS22/4), we noted ESG data and ratings services are increasingly embedded within investment processes, directly influencing capital allocation. To avoid potential harm to markets and, ultimately, consumers, we consider that ESG data and ratings services should be transparent, well-governed, independent, objective, and based on reliable and systematic methodologies and processes. We have worked to convene, support and encourage industry participants to develop and follow a voluntary Code of Conduct. We support introducing regulation in this area. We are working closely with Government on this, who are expected to shortly consult on whether and how to extend the FCA's perimeter to include ESG ratings providers.

As users of ESG data and rating products, benchmark administrators should ensure the underlying methodology for these products, whether provided by the benchmark administrator or a third party, is accessible, clearly presented and explained to users. Without transparency of these underlying methodologies and clarity on how they are being applied to a benchmark, it may be difficult for users to interpret and compare outputs across administrators, potentially harming competition and end investors.

Low Carbon Benchmarks Regulation

The Low Carbon Benchmarks Regulation (UK version of Commission Delegated Regulation (EU) 2019/2089) amended the UK Benchmarks Regulation to introduce new categories of benchmarks and to provide for ESG-related disclosures for benchmarks. Here, we assessed the explanations of how ESG factors are reflected in the benchmark statement and methodology.

Benchmark Statements

Benchmark administrators must provide specific information on how the ESG factors are reflected in each benchmark or family of benchmarks. These disclosures should display the corresponding score of the relevant ESG factors at an aggregated weighted average value. The minimum content of these disclosures is set out in the UK version of the Commission Delegated Regulation (EU) 2020/1816. Mandatory ESG factors for which scores must be provided based on underlying assets are detailed in Annex II of the same regulation. Administrators may also choose to disclose additional weighted average scores.

We found most disclosures omitted key information set out in the templates. Whilst this information was often contained in other documents, this was not clearly signposted.

Furthermore, all benchmark administrators in our sample failed to provide sufficient information on the data and standards used to calculate the weighted average scores for their ESG factors. Descriptions of the data sources and the extent to which they are estimated or reported were particularly poor.

We observed that several firms were not disclosing average weighted scores against all of the mandatory ESG factors detailed in Annex II. If administrators do not have access to the relevant data to comply with this requirement, they should obtain it or consider whether they should cease offering those benchmarks for use under the UK BMR. Firms should contact us before making any decisions regarding ceasing benchmarks. Finally, where benchmark administrators are disclosing scores in addition to the mandatory scores, they should flag that these are being voluntarily disclosed.

Benchmark Methodologies

Benchmark administrators are required to list the ESG factors taken into account in their benchmark methodology and state whether these are being used for selection, weighting or exclusion. Benchmark administrators must provide information on the data and standards used, describe how data is verified and the quality of data is ensured, and describe any international standards used in the benchmark methodology. The minimum content of these disclosures is set out in the UK version of the Commission Delegated Regulation (EU) 2020/1817.

Similar to our findings above, most firms in our sample omitted vital information contained in the template. Some firms only provided information detailing how the ESG factors used in their methodologies are calculated. We expect firms to state which factors are being applied to which benchmarks and whether these factors are used to select, exclude or weight constituents.

Again, all benchmark administrators did not provide sufficient information on the data and standards used. Descriptions on how data is verified, and how the quality of data is ensured were particularly poor.

Robustness and Reliability of ESG Benchmarks

Benchmark administrators are required under Article 12 in the UK BMR to use a methodology for determining a benchmark that is robust and reliable.

During our engagement with firms, we became aware of several instances where benchmarks had been miscalculated due to the incorrect application of ESG factors. We found administrators had assessed constituents against outdated ESG ratings and data or failed to apply their ESG exclusion criteria when rebalancing. We observed that some administrators did not have adequate controls in place to verify that ESG factors had been correctly applied in their ESG benchmarks.

We expect benchmark administrators to have sufficient systems and controls in place to ensure they comply with the requirements of Article 12 on an ongoing basis. This means that administrators are expected to ensure that all these requirements are met each time the methodology is implemented, and the benchmark is determined.

In our portfolio letter, we said that we expect benchmark administrators to notify the FCA where they suffer incidents taking into account certain factors. For ESG benchmarks, administrators should also consider how their users' and end-users' non-financial objectives may have been impacted.