The Future of ESG investment – How International Standards & Modern Data Analytics Integrate ESG in Mainstream Investment and Create the New Normal

Executive Roundtable Summary

Virtual Conference – January 27-28, 2021

Background

There is now global acknowledgement that the climate crisis is posing an immediate threat to business and financial markets. In addition, companies with vulnerable supply chains, questionable labor standards, and a inability to innovate in the face of environmental and social challenges are especially exposed to financial risks. Leading financial institutions have reacted to these risks by integrating Environment, Social and Governance (ESG) considerations into their portfolio management, and they have created international standards through initiatives such as the Task Force on Climate Related Financial Disclosures (TCFD). ESG data analytics are becoming an integral part of investment decisions. Meanwhile, ESG-related opportunities are also gaining in importance, with the framework of the UN SDGs serving as an important reference, while total impact measurement concepts are sitting at the doorstep to finally put an end to externalizing important costs of business action. This Roundtable was designed to review the latest developments in ESG investment standards and data analytics. With a 50:50 split between North America and Europe participants, 42 senior executives, joined the conversation, including 23 representatives from 18 global companies, 14 from eight financial organizations, and five from NGO/academia.

Participants

Host

- Todd A Bridges, Partner, Global Head of Sustainable Investing & ESG Research, Arabesque

Moderators and Facilitators

- Arabesque: Andreas Feiner
- Orbia: Cristina Gil
- The Chemours Company: Sheryl Telford
- Value Balancing Alliance: Christian Heller
- Yale University: Daniel Esty
- World Environment Center: Glenn Prickett

Speakers

- BP: Kelly Goddard
- Dow: Eunice Heath
- Duke Energy: Katherine Neebe
- Impact Management Project: Clara Barby
- Jacobs: Zoe Haseman
- JP Morgan Chase & Co.: Marisa J. Buchanan
- LafargeHolcim: Magali Anderson
- Novartis: James Wallace
- PRI: Nathan Fabian
- SAP: Daniel Schmid
- SASB: Janine Guillot
- State Street Global Advisors: Benjamin Colton
- UNJSPF: Herman Bril

Key Points

(1) **Poll questions during the Roundtable** revealed that all participants confirmed that ESG related data requests have risen in quantity and became more complex and that they witnessed a growing interest by their company Boards in sustainability. Asked to what extent company representatives have the data available to communicate with their investors on material ESG issues: 60% responded yes, 40% said no.

(2) **ESG integration into standardized frameworks**: 2020 has been the year in which the single most coherent standardization of frameworks and standardization related to ESG disclosure has taken place. Mainstream investors such as BlackRock and others have entered the field as a response to their need for quality information to deliver financial returns at low/moderate risk. In addition to new EU regulation, five major private global organizations, SASB, TCFD, GRI, CDSB, and the Integrating Reporting Framework (IR), have collaborated, culminating in the IFRS foundation trustees issuing a consultation on whether they should play a role in the consolidation process. Financial institutions are now united in a common wish for a generally accepted harmonization of ESG disclosure with minimum mandatory KPI's be added to traditional financial accounting standards. Beyond that, they expect a continued proliferation of competing standards, because investment houses need to differentiate themselves and because different stakeholders and sustainability issues merit their standards.

In parallel to this development, the European Commission's "Sustainable Finance Disclosure Regulation" (SFDR) is now mandatory, expecting financial service providers to disclose how they consider sustainability issues in their strategies, processes, and products. Knowing that the definition of a commonly agreed-upon set of indicators to assess ecologically sustainable economic activities is still a key challenge, the EU refers to its classification system, the newly developed, almost finalized EU taxonomy. By January 2022, each financial product issued in the EU must carry these disclosures.

The big question in the room was whether European leadership may force global framework setting to adopt the EU standards? Several experts expressed their doubts, especially since they expect that global and US-dominated standard bodies will insist on strictly business-relevant indicators. Other experts were less skeptical, convinced that the relevant actors will grab the pragmatic opportunity for harmonization, underscoring that EU regulation is too advanced to be changed and that the TCFD recommendations have already been integrated with its approach. There was consensus among the experts, however, that harmonization of standards and rules is taking place at a fast pace – with a good chance that 2023 will see a global standard that defines a limited set of mandatory, highly business-relevant key indicators to be reported and evaluated.

Another key trend has been expressed: investors with huge portfolios increasingly request and use raw data for their own company evaluations, starting with the commonly accepted business-relevant indicators developed through SASB and TCFD. From here, investors may take up additional industry-specific indicators for their evaluations and thus differentiate themselves further from competitors.

(3) **Decision-useful insights through data analytics:** Standards, Frameworks, and regulations create a common basis for companies to report the data requested by capital markets and other stakeholders.

Given that companies report high-quality data, technology can then enable much more accurate and comparable sustainability assessments of thousands of companies than known so far. Vice-versa, technology can enable companies to report the data required at a lower cost and to a greater extent.

However, current and upcoming technology can not only help generate quality data, but it also enables developing applications that transfer sustainability data into decision-useful insights. A few applications that can be generated (by simply clicking on a button) were introduced during the Roundtable:

a. *a "trust score",* enabling to quantify the impact of trust on a company's financial performance;
b. *a "temperature score"* used in low carbon indices: it quantifies how companies are contributing to the rise in global temperature through their GHG emissions. Corporations receive a near-term and long-term temperature score reflecting the pathways they are on given their current behavior: it can be used to favor companies that are aligned with 1.5° and 2° pathways;
c. *peer group analysis* to monitor the ESG performance of competitors;
d. a *human rights tool* to evaluate a company's risk exposure concerning existing or new business opportunities;
e. a *supply chain tool* to understand key suppliers' ESG performances, something that can be part of a temperature score of a company's scope 3 emissions.

Technology can and will enable many more applications, while ultimately finding its raison d'être above all in being the central source for universally accessible, raw sustainability data. In this function, it provides companies and investors the opportunity to access and integrate ESG data into decision-making processes. Transparency and trust in the raw data are especially critical to enable that function.

(4) To Manage Risk and Create Sustainable Long-Term Value through ESG data analytics, experts recommend that company executives first understand which business and associated sustainability challenges are (financially) material to the company. Reporting information only because it can be measured, doesn't mean the data helps in decision-making. Instead, what matters should be measured. It is critical that companies develop the infrastructure throughout the corporation to gather ESG-related information and structure it for management decision-making.

However, although ESG data analytics is an effective way to measure the impacts of the business, top management must fully understand and back the strategy derived from the data and tell the narrative behind it. Several options were recommended to strengthen accountability, such as combining the achievement of mid-term sustainability goals with compensation programs, performance reviews, etc.

Roundtable participants observe that investors sense an age of new risks and opportunities, ultimately asking the question: "who is ready for the transformation taking place"? As preferences of investors are beginning to change, they demand creativity and innovation. This goes beyond technology and includes management, collaborations, public engagement, communication, etc. For climate change a good, functioning framework for decision-making has been developed through the CDP, Science-Based Targets Initiative, TCFD, and the Paris Agreement. However, roundtable participants are concerned that this is not yet the case for other very pressing topics such as biodiversity loss, the marine environment, diversity & inclusion, to name a few. In addition, a "maturity measurement" of a company's ability to take on a challenge, e.g. if a company is rising or falling, is expected to evolve.

(5) How to attract long-term investors: Long term, ESG-conscious investors have become a significant group as they are reported to already hold a third of invested shares of some global companies. They increasingly expect that the corporate strategy reflects sustainability goals and that top management takes account of these goals. Different from five years ago, they are now well prepared and understand the connections very well. The adoption of the TCFD has clearly shown that meaningful and well-managed sustainability goals have a strong impact on the company's ability to communicate its ability to manage risks. Other business-relevant global risks (and opportunities), sometimes specific to the company, are now often expected to be managed with equal seriousness, as investors are gaining a better understanding of the topics, and even better data they can refer to. Leading companies have already demonstrated this ability to initiate a major transition away from unsustainable products in reaction to climate change while keeping a holistic approach to sustainability. Although only executing a bold strategy is convincing over the longer term, financial markets have shown that they honor a clear message concerning the transitioning of the company into a carbon restricted world.

Other companies, those with less risky products, are not automatically gaining confidence within the financial community. Within their sector, they attract long-term investors by bold target-setting that includes business-relevant sustainability issues well in advance of competitors, and by increasingly attracting the best talents and most ambitious customers, which they increasingly do because they are perceived as a sustainability leader. But this is not the only reason why investors reward sustainability leaders. Sustainability leaders are perceived as being able to find new customers who need the expertise to solve new challenges associated with global change: since leaders have gone through most of those challenges themselves and found practical solutions, they are the best to design products and services that work. That's how business opportunities evolve. And last but not least: companies that have integrated sustainability and financial data and understand correlations can easily show how much savings they achieve by setting new goals. Although some companies may fear the risk of reporting data that reveals undesirable trends, roundtable participants recommend disclosing them anyway as it helps to solve inevitable problems. An intermediate step that can help maybe to first share those data internally and learn from the internal discussion before proceeding to public disclosure.

(6) **The UN Sustainability Goals** were not designed for investors and neither with their help. And most companies, although finding value in the SDG framework, in general, have little understanding of how to measure their impact, let alone how to communicate to financial markets any impacts that they have on the SDGs. Roundtable participants stated that they hardly get questions from investors related to their strategy and impact concerning the SDGs.

However, including the SDGs into investment decisions has already been taken up by some large institutional investors who find extra financial value in them.Stating that the SDGs help identify positive social/environmental impact, these contributions may lead to more business opportunities, meaning that an investment can become interesting. That is why two major initiatives have recently developed:

(a) a group of institutional investors led by Dutch investors designed the "SDI Asset Owner Platform," a sustainable investment tool based on the SDGs that helps investors through standardized taxonomy to identify companies who contribute to the SDGs with their products & services or their operations & conduct.

(b) cooperation between academics and investors in the UK designed "The Sustainable Investment Framework", which provides investors with a way to holistically measure investment outcomes against all 17 SDGs, concentrated into a dashboard of six core themes and associated metrics.

Both initiatives are starting points that are expected to evolve. They show that investment markets are further developing, with ESG integration being supplemented by opportunities that the SDG framework addresses. As measuring impact is a very difficult undertaking and more data is needed for these analytics, the major driver of these developments is digitization.

(7) **Total impact valuation emerging, although not yet widely applied:** Capital markets increasingly refer to information beyond current financial statements that provide a more holistic understanding of how companies are performing. That is due to new regulations, international norms, investor preferences, and industry disruption. ESG reporting frameworks such as SASB are helping to provide comparable data on sustainability matters that create or erode enterprise value. With *total impact valuation,* a concept has emerged, that takes account of additional parameters measuring the creation and destruction of value. Among the leading initiatives developing standardized and practical methodologies to impact valuation are the Value Balancing Alliance and the Impact Management Project.

Total impact valuation methodologies aggregate the economic value with the environmental cost/value and the social cost/value from the company activities. Experts made clear during the Roundtable, that we need to be very careful about how that data is being aggregated. A simple example is that human rights abuses cannot be traded off e.g. by high salaries for employees, and high carbon emissions can't be compensated by other values either. Evaluating a company from diverse angles is not simply a matter of data availability, but also of balanced storytelling. While this should be a global conversation, the business community has raised concerns as the European Commission leads the discussion in a rather internally focused way when a dialogue with the IFRS, SASB, the GRI, etc. would be helpful.

It should be noted that impact valuation is not only in the interest of investors. It is even more important for strategic decision-making within the company. An example is e.g. understanding the total aggregated costs of production in a certain location compared to an alternative location, or e.g. financing carbon credits versus purchasing renewable energy.

Note: WEC Executive Roundtables are conducted under the Chatham House Rule.