Synechron

Mapping the ESG Landscape: Complexities, Complications and Considerations

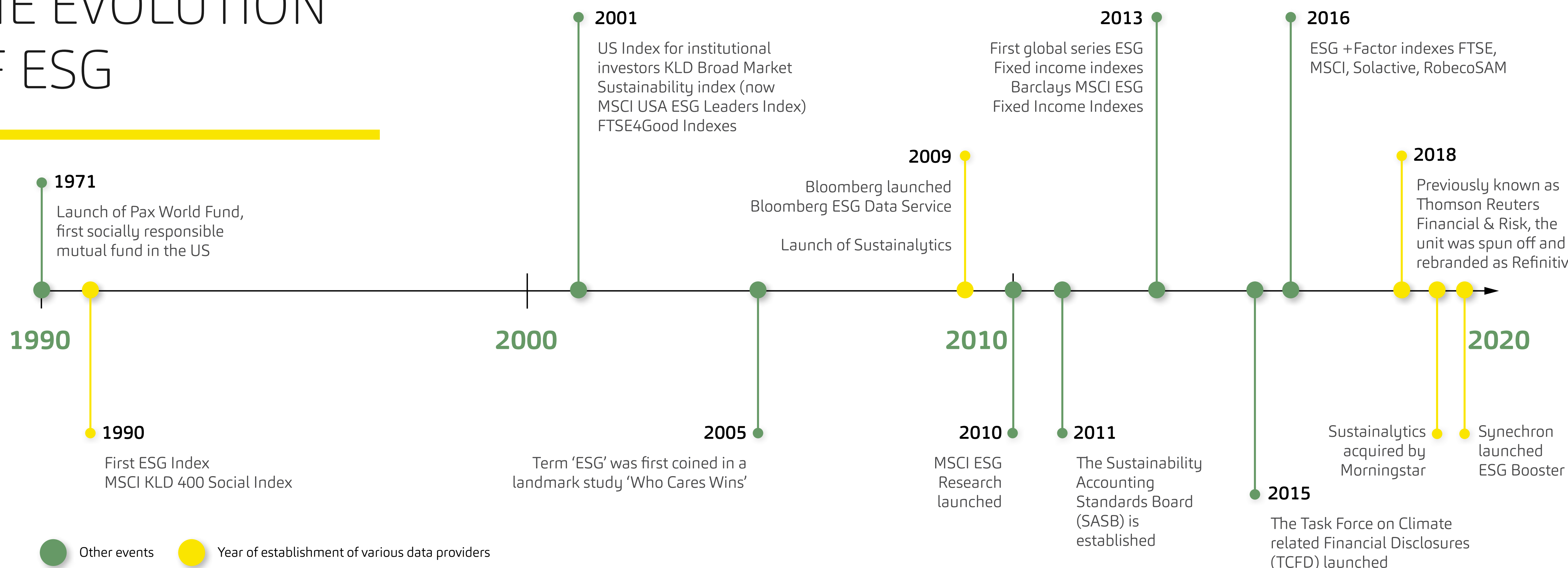
Authored by:

Rajul Mittal
Head of Sustainable Finance
Synechron, The Netherlands

Bermet Dordoeva
Senior Consultant
Synechron, The Netherlands

Hachem Ohlale
Head of Analytics & Data Science
Synechron, The Netherlands

THE EVOLUTION OF ESG



The Industrial Revolution was the catalyst for not only unprecedented scientific development, but also the onset of considerable CO2 emissions. Cumulative greenhouse gases emissions over the last couple of centuries have led us into a time where the world needs to focus on a wide and growing array of Environmental, Social and Governance (ESG) issues. ESG concerns are central to the larger Sustainable Finance movement itself which has become mainstream in recent years.

The first, early iteration of ESG, in concept, dates back to 1960. That was followed by the 1971 launch of the very first mutual fund, the Pax World Fund, dedicated to then-called 'socially responsible investing'. That definition has evolved over the years, with both exclusionary and inclusionary investing mandates in focus. Up until about 1990, few took notice of the climate impact as long as the economy was thriving, and shareholder value was created. But those two worlds have since collided.

In 1990, the very first US ESG index was born, followed by the creation of the first global ESG index nine years later in 1999. In 2004, the former UN Secretary General Kofi Annan wrote to more than 50 CEOs of major financial institutions, inviting them to participate in a joint initiative whose goal was to find ways to integrate ESG metrics into capital markets. The term "ESG" was coined in 2005, as part of this initiative, which included the release of the report "Who Cares Wins".[i] It stated that embedding ESG factors into capital markets makes good business sense and leads to more sustainable markets and better outcomes for societies.

Demonstrating progress toward taming the growing datasets and disclosures, the non-profit Sustainability Accounting Standards Board was founded in 2011 to develop sustainability accounting standards.[ii] That was followed by the 2015 launch of the non-profit Task Force on Climate-related Financial Disclosures to promote climate-related exposures and advance market transparency and stability.[iii] In the last five years we have started to see unprecedented attention to ESG by various financial market participants.

Starting with EU Taxonomy, which was adopted in July 2020, the European Union is continuing to build a solid regulatory base to make sustainable finance work. Sustainable Finance Disclosure Regulation (SFDR) came into force in March 2021, followed by the review of Non-Financial Reporting Directive (NFDR) and a proposal to widen the scope for disclosures to SMEs (Corporate Sustainability Reporting Directive) in April 2021. These changes will bring more data into the ambit of ESG, since more and more companies will have to disclose their sustainability matters in a standardized format in the coming years. Of note, ESG is being considered not only for long term risk mitigation, but also for proactive alpha generation. We expect the integration of ESG to grow further within the global financial industry at a considerable pace.

> *"...ESG is being considered not only for long term risk mitigation, but also for proactive alpha generation."*

THREE PILLARS TO A BETTER WORLD

Defining the three pillars

The global industry currently recognizes three pillars that constitute ESG as a set of metrics. These are the array of criteria that help measure and decide what falls within the sustainability universe for businesses. There is a strong link between ESG metrics and the 17 UN Sustainable Development Goals (SDGs) – adopted by all UN Member States in 2015.[iv]

- **Environmental** factors include carbon emissions, efficient use of water and energy, waste management practices, and other items related to climate change

- **Social** factors focus on how a business impacts & interacts with society. Key social factors are supply chain and product responsibilities, human rights issues, labor laws etc.

- **Governance** factors include shareholder rights, the corporate board of directors including gender equality/representation, and the company's compensation policies

Why does ESG matter, anyway?

ESG is becoming an important part of the risk framework in financial institutions.[v] Mitigating ESG investment risks and transition to a sustainable economy are viewed as key drivers for ESG adoption. Moreover, mitigating ESG risk in a portfolio is a significant consideration for institutional investors. These drivers are backed up by a Harvard Law School survey[vi] which found that nearly one-half (46%) of institutional investor respondents said they view ESG as a fiduciary duty, and an equal percent felt they must meet/get ahead of regulation, while a still sizeable 44% of respondents said their goal is to mitigate ESG risk. What's more, this survey found that institutions with more mature ESG policies in place are more heavily influenced by global initiatives, such as those of the United Nations- supported Principles for Responsible Investment or the non-profit Sustainability Accounting Standards Board (SASB) framework.

We firmly believe that the best use of ESG data is to facilitate change and make the impact measurable. This has also been manifesting in several ways across the investment ecosystem, and we foresee ESG linked investment opportunities blossoming:

- **Green Bonds** – The so-called 'Green Bond' market has ballooned from US$36 billion in 2014 to US$257 billion in 2019.
  Coming next: Social, Sustainability, SDGs, and Transition bonds

- **Retail Investing** – More than one-half of millennials and GenZers prefer sustainable products.
  Coming next: More sustainable investing products for retail investors

- **Impact Investing** – More than 1,720 organizations managed US$715 billion in impact investments in 2019.
  Coming next: Impact measurement practices are expected to mature [vii]

- **Sustainable Borrowings** – The Sustainability-linked borrowing/loan market is growing at a rapid pace.
  Coming next: Sustainability-linked target setting is becoming science based, transparent and comparable

CHALLENGES TO FURTHER ESG ADOPTION

What are the challenges to further ESG adoption by institutional investors?

According to the Harvard Law School survey previously mentioned, 44% of institutional investors said the lack of reliable or consistent ESG research/data is the biggest barrier for their organization in accelerating ESG adoption.

As of 2018, 85% of S&P 500 companies were generating Sustainability Reports, versus only 20% in 2013.[viii] A 2020 report from the Governance & Accountability Institute observes that as of 2019, that number had risen to 90%.[ix] Currently, ESG data sources include:

- Annual reports/sustainability reports
- Company websites
- NGO & government reports
- Stock exchanges
- News and social media
- Third-party data providers

Abundance of inflowing data should make ESG evaluations easier. However, while a plethora of data is available, that data is highly fragmented, is found in differing formats and languages, and primarily available as unstructured data. Additionally, self-reporting is often suspect, as reporting and underlying data is not under regulatory scrutiny nor audited. "Greenwashing" – where a company deceitfully reports environmental practices/initiatives, or attempts to 'spin' what it does, or even ignores negative events altogether – can be problematic as formal audits are currently absent. A 2019 ESG study of EU based asset & wealth management firms found that only 13% rely on their in-house data.

The key questions then become:

- What is 'sound' data?
- What data should we use?
- How can we make sense of it?
- How do we perform appropriate analysis?

Understanding the differences among third-party data providers

Third-party ESG data providers are quite divergent in terms of criteria, definitions, asset coverage, regional or global coverage, industry-specific coverage and other factors. This results in differences with respect to ESG data, scores, ratings, and rankings, which can be daunting to sort through and understand.

Key differences among third-party data providers:

- **The type of data used** – current and/or historical and the quality of data used
- **The methodology deployed** – toward assessing data inputs, such as to weightings/indicators
- **Coverage area analysis** – across different asset classes/global markets
- **Scale and frequency of analysis** – including once per year versus quarterly, versus in-real-time analysis, risk scoring, range and depth of analysis

Lack of standardization and comparability with respect to ESG data makes genuine insights difficult to obtain. Synechron classifies third-party ESG data providers into four main categories.

> *"One of the biggest challenges is not that we are seeing more and more ESG data providers, but that ESG data lacks consistent methodology and structure."*

CATEGORIZATION OF DATA PROVIDERS

1

Globally focused data providers

Global ESG data providers having a wide coverage in terms of geography, asset class, etc.

2

Traditional market data providers

Traditional providers of market data that also include ESG as one of the service offerings

3

Niche data providers

Data providers having a niche approach in terms of coverage and/or input data feed

4

ESG analytics platforms

Data and technology providers of analytics platforms that often make use of third-party data

What makes comparing data such a difficult task?

As confirmed by a study conducted at the MIT Sloan School of Management, ESG ratings diverge substantially across the major data providers.* Contributing factors include:

- **Corporate stock and bond prices** are unlikely to properly reflect ESG performance as investors struggle to accurately identify out-performers and laggards
- **The divergence can dampen the ambition of companies** seeking to improve their ESG performance, thanks to the mixed signals they receive from ratings firms
- **Main factors contributing to divergent ESG rating** are namely differences in terms of measurement technique (50.1%), scope (36.7%) and weight (13.2%)
- **Lack of consistency and conformity** for credible comparisons across data sets. As a result, some companies avoid disclosing information that could potentially cast them in a negative light

ESG DATA PROVIDERS

Looking across some of the mainstream ESG data providers, differences are clear

In line with other studies, Synechron has found a lack of consistency among how corporate ESG data is collected, analyzed, ranked/rated/scored and presented.

Furthermore, Synechron's targeted outlier analysis of 82% of S&P 500 companies, based upon data from two leading ESG data providers found the following.
The outlier score is depicted as a percentage showing the difference between normalized ESG scores across data providers based on industry level ranking scale:

- 11% of the companies got a high score
- 48% of the companies got a moderate score
- 41% of the companies got a low score

Our research showed that S&P 500 companies with a high (11%) and moderate (48%) outlier score showcased significant differences in ESG ratings.

Key Characteristics

	SUSTAINALYTICS category 1	MSCI category 2	REFINITIV category 2	BLOOMBERG* category 2	Orenda** category 3	REP RISK*** category 4	TRUVALUE LABS**** category 4
Industries	All industries						
Environmental Rating	✓	✓	✓	✓	✓	✓	✓
Social Rating	✓	✓	✓	✓	✓	✓	✓
Governance Rating	✓	✓	✓	✓	✓	✓	✓
Overall ESG Rating	✓	✓	✓	✓	✓	✓	✓
Rating Scale	0-100 (risk score)	AAA to CCC	0-100	0-100	0-5	AAA to D	0-100
Qualitative Reports	✓	✓	✓	✓	✗	✗	✗
ESG Related News Feeds	✗	✗	✗	✓	Social media	✓	✓
Portfolio Screening Tool	✓	✓	✓	✓	✓	✓	✓
Frequency of Updates	Yearly	Yearly	Yearly	Yearly	Every 10 mins	Daily	Near Real-Time
ESG Issues	20 material ESG issues	35 ESG key issues	10 ESG categories	13 (E&S) & 4 (G) issues	34 ESG metrics	28 & 57 indicators	12 & 30 indicators
Historical Data	Undisclosed	11 years	+/- 18 years	10+ years	5 years	>12 years	10 years

Please note: Overview is per Q2,2021 and is constantly evolving

* In 2020, Bloomberg launched its own ESG scores, an initial offering that includes Environmental and Social (ES) scores for the Oil & Gas sector, Board Composition scores and ESG Disclosure Scores for multiple industries
** A high frequency ESG Scores and insights into a company's reputation and commitment to its community's shared beliefs
*** Indicators include 28 based on UN GS Principle and 57 topics under ESG
**** Truvalue Labs is an AI powered ESG insight and analytics platform providing tailored ESG data and rating solutions. Indicators include framework of 12 and under SASB there are 30 categories

ADDRESSING THE CHALLENGES

What can you do to address these challenges?

There is no doubt that the ESG data landscape is constantly evolving. Currently there is no convergence in terms of ESG standards. For now the best strategy to move forward is keep a tab on the market and align accordingly.

The bottom line is that there is no one-size-fits-all solution. Most of our clients are now starting to explore which ESG data provider to use. Relying on third-party data, news data only, or self-reported data each approach has its own benefits and drawbacks.

At Synechron, we believe there are certain key tenets that should be embraced as we move towards a more reliable and standardized ESG data landscape:

1. ***Diversify the collection of ESG data sources and focus on data quality & granularity***

Two types of ESG datasets are available on the market: first, "inside-out" (company self-reporting via sustainability and annual reports) and the second, "outside-in" (external third-party's views toward companies' ESG, i.e., ESG ratings, and news/media sentiment analysis scores). A fine balance between these two types of data will maximize the value of ESG and give a better understanding of what companies say and what they actually do.

2. ***Take a deeper dive for granularity***

ESG is a good proxy when talking about sustainability, but ESG covers many sub-issues and can vary per sector and even per company. ESG data analysis should go one level deeper to different parameters which are material for the companies' core business. More granularity on ESG data, such as GHG emissions and female/male ratio at the board level, provides a comparable basis among the companies and pointers for improvements.

3. ***Prepare for regulatory impact and data changes***

Requirements from Sustainable Finance regulations (EU Taxonomy, SFDR, and NFRD/CSRD, etc.) all emphasize transparency and data quality. A streamlined data collection, reporting, analysis, storage, and product design can ease the upcoming regulatory burden and unlock the new set of possibilities for businesses.

4. ***Invest in Data & Analytics capabilities to harness the full power of ESG data***

Organizations need to have a clear ESG data strategy in place to collect data from various sources based on their business needs. This should be expanded and enhanced with strong data management and governance capabilities to ensure ingestion, management, processing, security, governance and lineage of ESG data.

Investment in analytics & data science capabilities is crucial as the complexity of ESG data is growing rapidly. For example, machine learning and natural language processing are essential to be able to get proper insights based on collected structured and unstructured data. This includes techniques like:

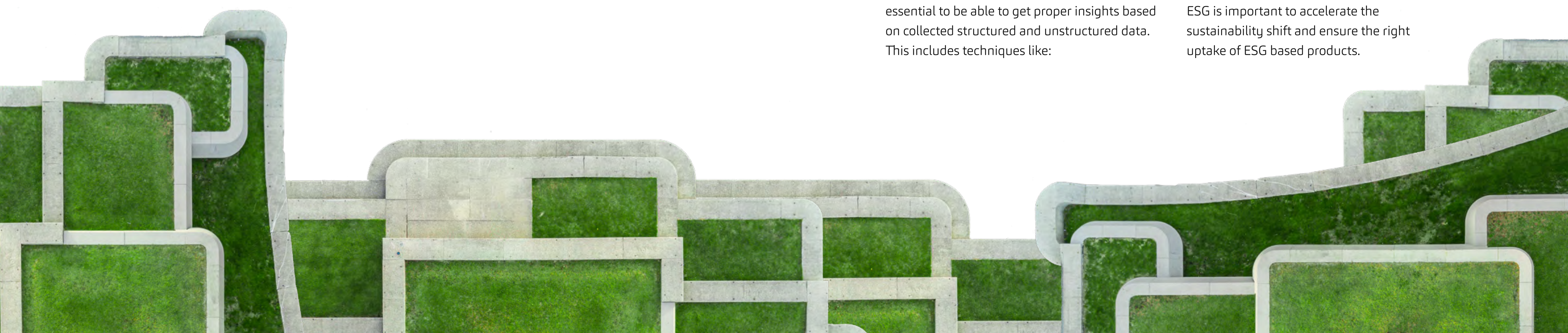
- News-based sentiment analysis feeding into ESG
- Social media data translated into ESG signals
- Knowledge graphs to detect related ESG controversies alongside supply chains

5. ***Cater to the needs of your audience***

Given that the topic of ESG is overarching and covers a variety of stakeholders, a wide range of expertise is required to fulfill their diverse needs. For example, expertise around data visualization can come in handy to be able to communicate ESG data-driven insights in an understandable manner to a wider audience including management.

6. ***Build up your ESG capabilities in parallel with the growing investment trend and satisfy/attract customers***

Provide adequate ESG trainings to existing employees undertaking a variety of roles i.e. investor relationships, procurements, and portfolio manager. Educating various stakeholders including clients with respect to ESG is important to accelerate the sustainability shift and ensure the right uptake of ESG based products.



About Synechron

Synechron is a leading digital transformation consulting firm focused on the financial services industry and is working to Accelerate Digital initiatives for banks, asset managers, and insurance companies around the world. Synechron uniquely delivers these firms end-to-end Digital, Consulting and Technology capabilities with expertise in wholesale banking, wealth management and insurance as well as emerging technologies like Blockchain, Artificial Intelligence, and Data Science. Based in New York, the company has 22 offices around the globe, with over 10,000 employees producing over $650M+ in annual revenue. For more information on the company, please visit our website or our LinkedIn community.

Synechron has created ESG Booster, one of the innovative business solutions that are part of our InvestTech Accelerator program. This suite of digital tools were built to address the specific needs of buy-side industry financial services firms, including wealth managers, asset managers, private banks, pension funds and insurance companies. Our ESG Booster helps our clients facilitate an ESG-based portfolio overview to:

- normalize different ESG ratings, ranking, and scores
- achieve better portfolios without compromising financial performance
- engage with portfolio companies on ESG issues at a granular level
- predict the ESG impact towards portfolios based on news sentiment analysis

To learn more about Synechron's perspective on ESG data analysis or to talk to us about potential solutions to up your ESG game, reach out to: InvestTech@Synechron.com.

Resources

[i] https://d306pr3pise04h.cloudfront.net/docs/issues_doc/Financial_markets/who_cares_who_wins.pdf

[ii] https://www.sasb.org/about/

[iii] https://www.fsb-tcfd.org/about/

[iv] https://sdgs.un.org/goals

[v] https://www.fitchratings.com/research/fund-asset-managers/nascent-social-bond-fund-sector-faces-implementation-challenges-14-12-2020

[vi] https://corpgov.law.harvard.edu/2020/01/13/into-the-mainstream-esg-at-the-tipping-point/

[vii] https://thegiin.org/assets/GIIN%20Annual%20Impact%20Investor%20Survey%202020.pdf

[viii] Raising the Bar on ESG Data Integration, 2019 – TrueValue Labs

[ix] 2020 Flash Report S&P 500, June 16, 2020 – Governance & Accountability Institute, Inc.
https://www.ga-institute.com/research-reports/flash-reports/2020-sp-500-flash-report.html

[x] Why ESG ratings vary so widely (and what you can do about it), August 26, 20189 -- MIT Sloan School of Management
https://mitsloan.mit.edu/ideas-made-to-matter/why-esg-ratings-vary-so-widely-and-what-you-can-do-about-it

Additional Resources:

Getting Started in Sustainable and Impact Investing: A Guide for Retail Investors -- The Forum for Sustainable and Responsible Investment (US-SIF)
https://www.ussif.org/howdoisri

GIIN Annual Impact Investment Survey 2020
https://thegiin.org/assets/GIIN%20Annual%20Impact%20Investor%20Survey%202020.pdf – Global Impact Investing Network (GIIN)

Sustainability-Linked Debt Ties Borrowers to ESG Goals -- Fitch Ratings Report
https://www.fitchratings.com/research/fund-asset-managers/nascent-social-bond-fund-sector-faces-implementation-challenges-14-12-2020

Aggregate Confusion: The Divergence of ESG Ratings, May 17, 2020 – MIT Sloan School of Management: https://poseidon01.ssrn.com/delivery.php? ID=575102124071
0700900231060640800280680370490040060050301200890260960741181181160170711060980510290180320020670061031030040950961220260940480650-
75111121093001095081126069002034074003016126005087088031113010093002121098030103016067082096089112115096068020&EXT=pdf&INDEX=TRUE

Synechron

www.synechron.com