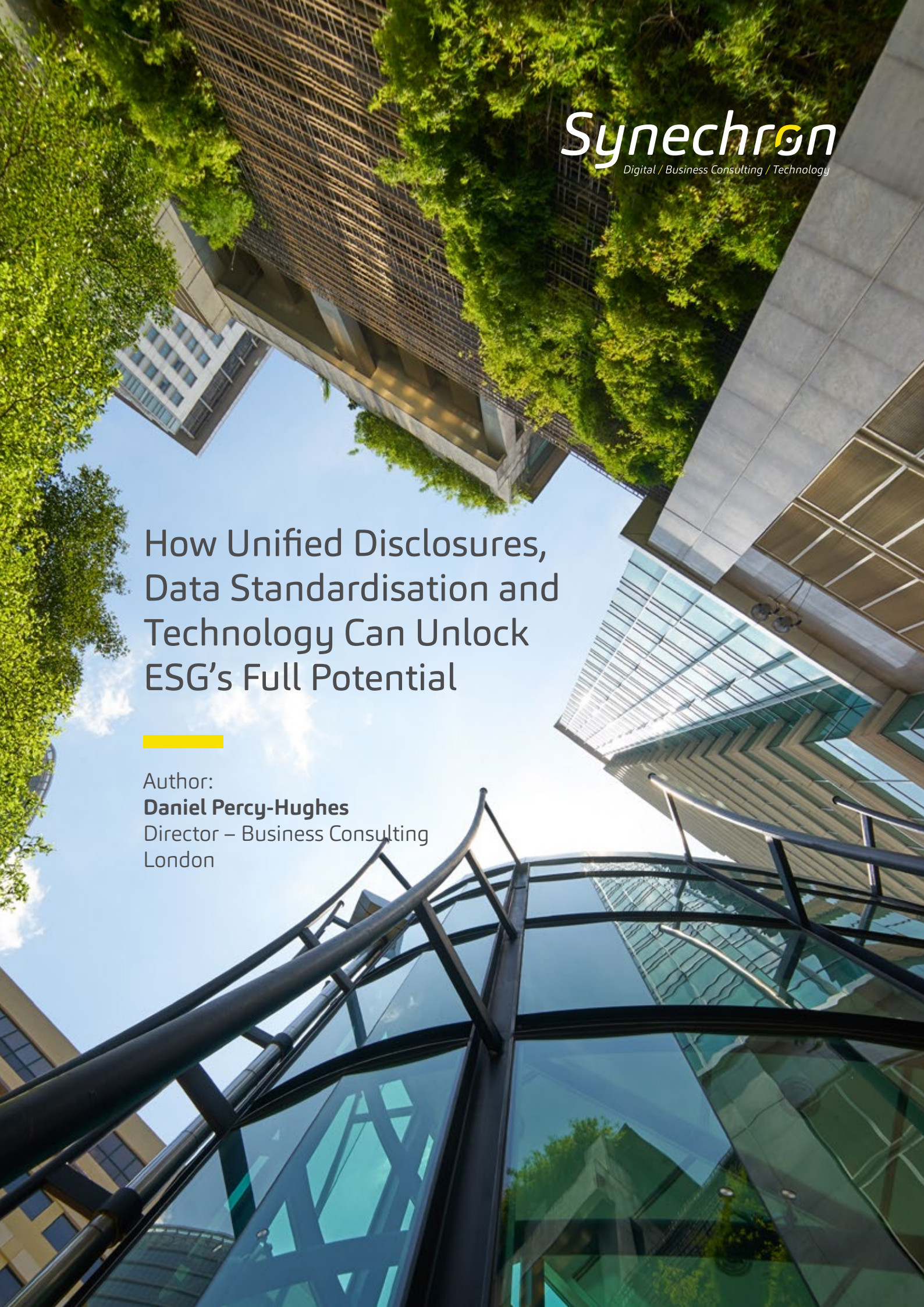

Synechron

Digital / Business Consulting / Technology

How Unified Disclosures, Data Standardisation and Technology Can Unlock ESG's Full Potential

Author:
Daniel Percy-Hughes
Director – Business Consulting
London

Environment, Social and Governance (ESG) is an increasingly growing area of focus for leading financial services (FS) institutions. With the sentiment that green business equates to good business, and shifting priorities toward sustainability in a new generation of investors, clients, and employees driving, FS firms are looking to scale up their ESG offering and make credible ESG investments. While ESG engagement can help firms create value and provide transparency, the creation of unified global disclosures, data standardisation and the use of technology are essential to unlocking ESG's full potential.

ESG factors are becoming integrated into investors' investment decisions and part of the advice offered to them by providers of financial services, such as banks, asset managers or insurance companies. While long-term quantitative data exists, it is of variable quality. Accurate comparison on ESG-related projects is difficult with data that is not standardized and where norms and averages have changed over time. Disclosures could be a way to improve the quality of that data.

Financial services is a global industry and the environment and sustainability are global issues. As such, there should be global standards and measures in place that cover all global markets. According to the European Parliament, the current "disclosure requirements set out in European Union (EU) legislation do not envisage disclosing all of the information necessary to properly inform end-investors (citizens investing in bonds, pension funds, investment funds and other financial products), about the sustainability-related impact of their investments." As a result, countries have created their own set of non-unified standards through a lens that favours commercial priority. This lack of disclosure benchmarks across member EU countries leads to inconsistent data and reporting that can lead investors astray when making financial and investment decisions. There is no basis of comparison available as each set of data standards and disclosures are different.

This leads to significant disparities in the accuracy, value, and importance of individual ratings, for reasons including: company size; geographic bias (more common than others); industry sector bias; inconsistency between rating agencies; failure to identify risk and the abovementioned disclosure limitations. Without a standardised, comprehensive rating system, such inconsistencies unfairly expose investors to risk and cast doubt on the overall legitimacy of a company's score.

For investment ratings and beyond, carbon has become the de facto measurement of environmental degradation to the exclusion of others. Even so, there are large inconsistencies with how carbon emissions are calculated, from company to company or geography to geography. Measurement of carbon tend to focus on emissions of point of consumption rather than production, that is exhaust gasses from a car rather than from producing the steel or building a car in the first place. In ESG, there should be no room for subjectivity when measuring carbon offset hence the need for disclosure unity and data standardisation.

The focus on carbon can mean other environmental factors, such as the cost of technology being increasingly overlooked. Although saving and storing files in a smart phone or on the Cloud reduces paper consumption, there are of course the environmental costs of running and cooling servers. Beyond this, a number of costs involved to produce a smart phone that are not factored in or considered by the average consumer. For example, at almost each step in any production process, including technology, water is a key but hidden requirement in the production process, known as virtual or embedded water. The water footprint of the production of a single mobile phone is estimated at a staggering 14,502 litres. According to a survey conducted by Gallup, the average American upgrades their smart phone every 2 years, making an individual's water footprint for smart phones alone at 72,510 litres in a decade. Water here is a clear measurable example. Consumption of rare elements should also be measured in the same way focus has been out on the finiteness of fossil fuels. All of these factors should be taken into consideration when producing ESG ratings for such technology firms.

Some associations are coming together to do what they can to increase standardisation and collaboration. In December 2018, the Loan Market Association (LMA) and Loan Syndications and Trading Association (LSTA) established four key principles to evaluate green financing, including: project eligibility;

an explanation of how the business is green via a committee or third party reports; the use of proceeds evidenced as green; and a reporting review where positive outcomes can be explained i.e., a green certification, visible signs of improved measures etc. Customers want standards that are recognised and which they can evidence. Some may want to be first and to be known for it, e.g. the first green collateralised loan obligation (CLO), though there is insufficient scale or standardisation to do this currently nor is there a mechanism currently in place to rate a green CLO.

While it is difficult to agree standards for environment ratings, the social and governance aspects of ESG are even harder to measure. If plastic is recycled or if metal is reclaimed using exploited or child labour in a developing or underdeveloped country, that has a high social and health cost that is not being including in a reported data set. Clear standards need to be defined that take the entire production network into consideration in order to have a circular economy that is restorative and regenerative by design. Materials constantly flow around a 'closed loop' system, rather than being used once and then discarded and their impact should be measured. As a result, the value of materials, including plastics, is not lost by being thrown away.

ESG remains a growing albeit immature part of the global economy. Firms become overwhelmed, even by acronyms and as a result, avoid asking why investors want i.e., a Sustainability Accounting Standards Board (SASB) disclosure. Data and disclosure standards are variable and can cause firms a high manual overhead, even more so for non-financial reporting. There is much room for technology to play a major role in the solution for reporting. At present, key terms in a sustainability document are being missed in manual data processing because of no Global Reporting Initiative (GRI) standards to pick up their relevance. Techniques like Optical Character Recognition (OCR) and Natural Language Processing (NLP) can extract the necessary data out of documents or online sources and show how progress can begin to be made.

Data, even if it is high quality, and its standardisation, only tells part of the ESG story and a qualitative judgement still needs to be made. Systemic issues also still need to be addressed as does coordinated change through disclosures the clever use of technology, all of which play a pivotal role in order to say if something is green or not. However, the enthusiasm surrounding ESG amongst financial services institutions and the work done thus far should not be discounted. Although data standardisation and disclosures are needed, the industry has yet to see the full benefits of ESG, opening the door to an exciting time of change. The time should not be viewed as a time of panic or confusion but a time of tremendous opportunity for the financial services industry to learn and contribute to this exciting ecosystem and help ESG reach its full potential.

Global Footprint

Synechron

Digital / Business Consulting / Technology

www.synechron.com | info@synechron.com