More standardization in corporate disclosures is needed to increase the quality and consistency of ESG data

BY JOLANDA DE GROOT

ESG data are at the heart of every ESG investment. Collecting ESG data has become increasingly important over the last decades. What are the challenges? Which improvements can be made? How will the COVID-19 crisis affect the collection of ESG data? Financial Investigator asked Wilco van Heteren, Executive Director in the Research Products team at Sustainalytics, the ESG and Corporate Governance research and ratings firm, of which Morningstar will become the sole owner, as has been announced recently.

Sustainalytics started back in 1992. What is the main difference between collecting ESG data back then compared to today?

'The main difference is that the amount of ESG data that is produced by corporates and other organizations is significantly larger today than it was almost 30 years ago. Over the years, we saw investors' attention, reporting initiatives and regulatory requirements increase. And companies themselves also started to see the value in collecting and using ESG data for their own benefits. These developments have led to an exponential growth in the availability of ESG data – in breadth as well as in depth. Consistency in corporate disclosure remains a challenge, though.'

What do your ESG ratings and underlying data measure? How do you aggregate different types of data and what decisions do you take in the process?

'While we offer a broader range of ESG research-based products, our ESG Risk Ratings measure the risk, associated with material ESG issues, that is not managed by companies. This unmanaged ESG risk for a company is the gap between the level of ESG risk exposure and the extent to which the company is managing that risk.

First, we determine which ESG issues may have an impact on the enterprise value of companies. We deem these to be Material ESG Issues (MEIs). For each sub-industry, a group of MEIs is selected based on a value-chain analysis. Then we determine, in a quantifiable manner, to which extent companies in that sub-industry are exposed to risks associated with these MEIs. We also define indicators that illustrate how companies manage these issues. What is the quality of their management policies and programmes? Do they address the relevant trends that we are seeing in those sub-industries? Finally, while on paper these policies and programmes may look strong, their effectiveness is challenged through our controversy research. Involvement in controversies means that we decrease the scores for the companies' management of the MEIs.

Since the Risk Rating is a number that expresses the magnitude of unmanaged ESG risk, all underlying parameters and components that constitute this rating need to be quantifiable. For some of these components we use company specific data that in themselves are already quantified, such as carbon emissions. For other components we translate a qualitative, yet highly structured assessment into scores in a way that can consistently be applied to all companies in a sub-industry.'

Within the financial industry there are critical voices saying that information provided by the various ESG data providers and ESG ratings firms can differ significantly. They say there is too little correlation in the outcomes of those organizations. Is that correct? If so, is that a bad thing?

'First of all, ideally there should be consistency in what corporates disclose. That is not the case at the moment. This inconsistency is one challenge that ESG data and research providers need to deal with. Better and more standardized corporate disclosure will increase the quality and consistency in data points collected by ESG research firms.

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How all these data points end up in a rating, depends on the methodology, which is exclusively developed and owned by each ESG ratings firm. This methodology is a reflective of an ESG ratings firm view on questions such as which ESG issues are material for companies and how one can best put a score to this materiality. Different methodologies may lead to different outcomes. Personally, I have no problem with that. Having said that, the ESG ratings firms should be transparent, to the extent possible, as to how they arrive at their ratings. This allows users of the ratings to compare the outcomes properly.'

Would the coronavirus crisis increase the importance of sustainable investments? Or would sustainable investments become less relevant? Is the topic being added to your research framework?

'The coronavirus crisis is an extreme example of how an exogenous, non-tangible factor can dramatically impact businesses. It is a phenomenon that has triggered lots of questions about the relationship between this virus – even if that is simply a biological 'creature' – and people's ways of living, travelling, consuming, et cetera. These issues are comparable to issues raised in the sustainable investment sphere. How sustainable are these patterns in human behaviour – from a planetary, a social and an economic point of view?

So yes, I would think the coronavirus crisis generates more attention for sustainable investments. Meanwhile we do see companies getting involved in COVID-19 related controversies, for instance around health and safety or data privacy. Whether and how a pandemic like COVID-19 might be addressed in our research framework more structurally, is something we are exploring.'

What developments in the area of ESG research might we expect to emerge or evolve in the coming five years?

'There are several areas where we can expect progress. Firstly, from an ESG content perspective, impact-oriented research will develop further. Secondly, I believe there will be stronger consensus on the terminology and definitions that will be used in ESG research, such as following the EU taxonomy on sustainable finance developments. Thirdly, while ESG research was mainly driven by the investor space, corporates have started to pay more attention to this research. This trend will likely increase further as corporates better understand how to benefit from closer integration of

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ESG factors into their own businesses – operationally, but also in their relationships with investors and other stakeholders. Finally, what we hope to see is further standardization in corporate disclosures as this will mean higher quality and consistency of ESG data.'

Recently it was announced that Morningstar will become the sole owner of Sustainalytics. What impact would that acquisition have on Sustainalytics?

'Ten years ago the Responsible Investment space aimed, among other things, to integrate ESG factors into mainstream investments. This ESG integration is no longer just an aim for the future – it is happening right now. The announcement concerning Morningstar and Sustainalytics is a manifestation of exactly that. We will continue on our path to develop ESG research-based products and to expand our business, while now being supported by a larger organization which has lines of business that could definitely benefit from our expertise in their existing offerings. A classic win-win, I would say.' «

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