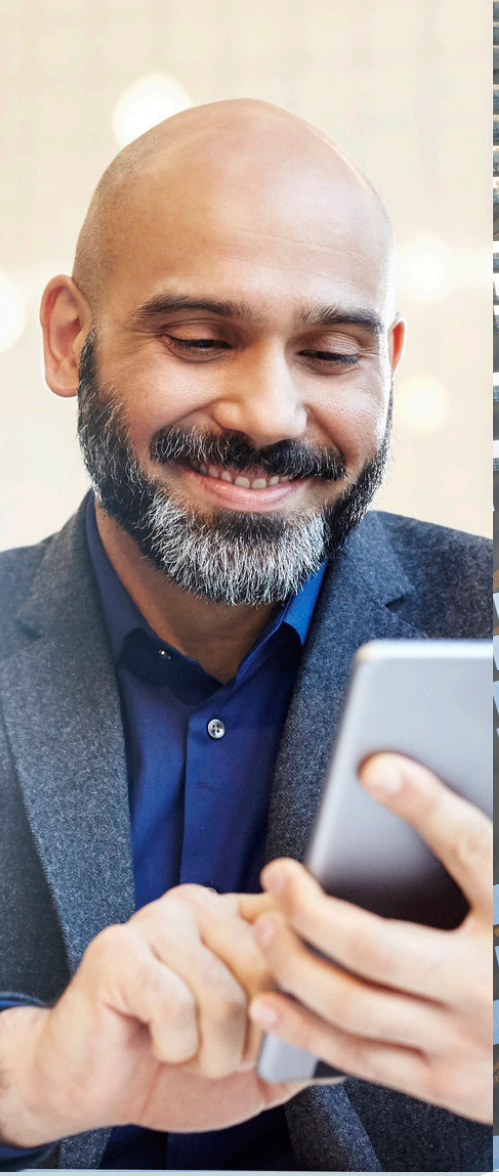

Future First℠ Insights

ESG Data and Regulatory Challenges in a Fast-Changing World

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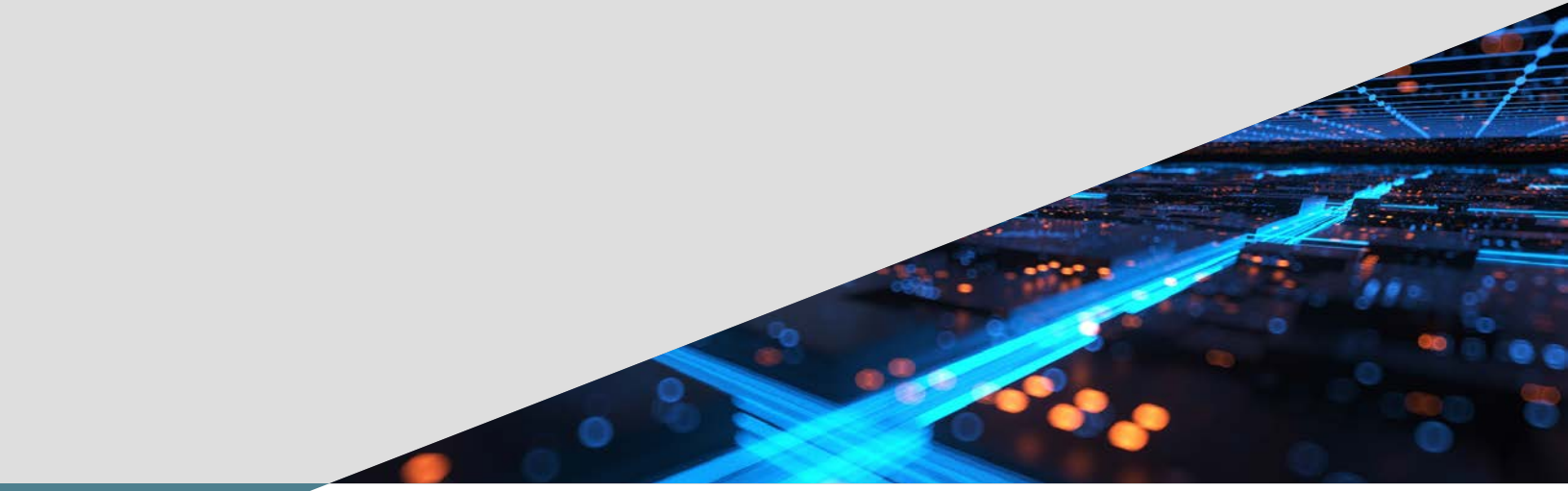
Consider Everything

Less than a decade ago, investment focused on environmental, social and governance (ESG) factors was a relatively small niche within the asset management world. Increasing awareness of the risks of climate change in the years since the Paris Agreement of 2015, extreme weather events that challenge human survival and threaten economic growth, and the coming of age of a new generation of investors that prioritize ESG considerations, are driving an increase in the scale of ESG investment and its importance within the industry.

Global ESG assets are likely to exceed $53 trillion by 2025, representing more than a third of the $140.5 trillion in projected total assets under management.[i] Put simply, investment management firms that ignore ESG considerations may risk losing clients and face investment underperformance as the world shifts to a more sustainable footing.

Institutional investors including asset managers, asset owners and pension fund providers require tools and transparency to make ESG investing a reality. To this end, many have already begun mapping their "impact processes" and integrating screening tools into their investment protocols, incorporating ESG priorities, obligations and expectations, along with a roadmap of regulatory compliance responsibilities. This process is a vast undertaking that is currently complicated by **inconsistent data quality** and **differing national and regional approaches to ESG regulation,** which creates particular challenges for global investors.

[i] https://www.bloomberg.com/professional/blog/esg-assets-may-hit-53-trillion-by-2025-a-third-of-global-aum/yeah



The Data Conundrum

The key challenges for asset managers when managing a fund that seeks to achieve a specific ESG objective are data availability, consistency and fitness for purpose. The absence of consistent, robust, verified and widely accepted data standards makes it is difficult to compare the ESG characteristics of a company that is a potential investment target against another. Data may be entirely missing for certain metrics and asset classes, excluding them effectively from investment analysis.

Equally, shortcomings in data have implications for the downstream obligations that arise from regulatory requirements. To comply with regulatory reporting requirements, risk managers need to be able to show that their investment choices are aligned with regulatory goals from an ESG perspective. It is essential to have a link between stated corporate goals, decision-making at portfolio level and reporting further downstream. Without it, an asset manager could face accusations of greenwashing and reputational damage.

In time, inconsistent reporting by underlying investee companies for foundational metrics will be addressed by initiatives such as the proposal by the European Union (EU) for a Corporate Sustainability Reporting Directive (CSRD), which will ensure in-scope entities provide consistent and comparable sustainability information. However, the CSRD is expected to apply to in-scope companies only from 2024; asset managers active in the EU will be required to report defined metrics at a product level under the Sustainable Finance Disclosure Regulation (SFDR) from July 2022. In the interim period, there may be considerable uncertainty about the availability and reliability of data.

ESG data can typically be sourced in one of three ways:

- First, companies may make ESG data publicly available in publications and the asset manager can collect it via its in-house research team. One problem with relying on such information is that there is no common standard for companies when reporting. Companies may also be tempted to use language and metrics that they think will appeal to investors instead of metrics and language reflecting their own corporate goals. Without predetermined standards, reaching a decision about which of two companies is the more climate-friendly, for example, is difficult.

- Second, the asset manager may obtain ESG data as part of its regular company visits to facilitate due diligence and analysis of potential investment targets. The more detailed engagement afforded by such an approach means that the asset manager has greater control over the information it sources and it is therefore likely to be more valuable when comparing one company against another. The downside of this approach is that it is resource intensive; even the largest asset management firms may find it difficult to source such information on their entire potential investment universe.

- Third, the asset manager can use third-party data providers to collate and provide ESG-related data relating to underlying investee companies. There is a wide range of such providers, including open-source providers, industry groups and data vendors. While third-party data providers are becoming more sophisticated overall, their coverage varies widely. The time periods and metrics collected relating to investee companies can also vary – data consistency is by no means guaranteed. Evaluating the approach of each provider is time-consuming. Given current limited coverage, it is very common for asset managers to use multiple data sources, requiring normalization across sources to blend data. As data is expensive, asset managers appreciate usage and coverage metrics in what is a very rapidly expanding market.

Industry Awaits Harmonization of Regulation Regimes

In 2015, under the Paris Agreement, 195 countries set a target to keep average global temperature change below 2°C and as close as possible to 1.5°C. At COP26 in Glasgow in November 2021, countries have now agreed to revisit their commitments, as necessary, by the end of 2022 to put the world on track for 1.5°C of warming, maintaining the upper end of ambition under the Paris Agreement. In order to deliver on these promises, participants at COP26 also agreed for the first time to accelerate efforts toward the phase-down of unabated coal power and inefficient fossil fuel subsidies, and recognized the need for support toward a just transition. All the while, the pace of regulatory initiatives focused on climate change and other ESG issues (designed to meet countries' Paris obligations) has quickened.

While the goal of various regimes is broadly similar – principally to limit carbon emissions to agreed limits by requiring companies and investors to publish exposures and other risk factors – approaches taken differ widely (see below section, "ESG Regulatory Approaches Around the World").

Most notably, some jurisdictions have voluntary regimes, such as those based on the recommendations of the Task Force on Climate-related Financial Disclosures (TCFD). Others are mandatory, such as the EU's SFDR, which is widely perceived to be the most advanced and ambitious.

Similarly, the emphasis of various regimes differs. The focus in Europe and the UK has been primarily on environmental factors (especially climate-related considerations) and in particular the disclosures needed to provide transparency to investors so that they can compare similar investments. In contrast, to date the U.S. has focused to a greater extent on the social aspects of ESG, although this could soon change given the prioritization of climate change by President Biden (symbolized by the U.S.'s return to the Paris agreement).

The fragmentation of ESG reporting frameworks, differences between regional regulatory approaches, the lack of standardized taxonomies that establish environmentally sustainable economic activities, and varying and complex data requirements are problematic, especially for firms that have operations in multiple jurisdictions. They may be subject to jurisdiction-specific ESG regulatory requirements and will face hurdles and ESG transparency requirements when distributing funds into other regions.

Over time, some of these disparities may be reduced. As the U.S. and other countries develop solutions to encourage investment in more sustainable economic activities, they are likely to draw inspiration from sustainability-related financial market regulations in other parts of the world.

ESG Regulatory Approaches Around the World

Europe

- The Sustainable Finance Disclosure Regulation (SFDR) contains transparency rules both at entity level and relating to financial products for financial market participants such as asset managers.
- The EU Taxonomy Regulation establishes an EU-wide classification system or "framework" intended to provide businesses and investors with a common language to identify the extent to which economic activities can be considered environmentally sustainable.
- A proposal for a Corporate Sustainability Reporting Directive (CSRD) will amend the existing Non-Financial Reporting Directive (NFRD) and ensure in-scope entities provide consistent and comparable sustainability information.
- The Markets in Financial Instruments Directive (MiFID II), Undertakings for Collective Investment in Transferable Securities (UCITS), the Alternative Investment Fund Managers Directive (AIFMD), the Insurance Distribution Directive (IDD) and Solvency II will be amended. The objective will be to ensure that in-scope entities, such as investment firms and insurers, include sustainability risks in their procedures and sustainability preferences in investment decisions for, or advice, to clients.

United Kingdom

- There will be mandatory economy-wide disclosures (including for the financial sector) in line with the Task Force on Climate-related Financial Disclosures (TCFD).
- The UK government has announced that it will implement a Green Taxonomy based on the EU Green Taxonomy.
- New Sustainability Disclosure Requirements (SDRs) look set to draw heavily not only from the TCFD but also from the EU's sustainability approach. SDRs will apply to financial services firms, companies and pension funds and will require them to report the impact of their organization and financial products on climate change and the environment, and the impact of climate change on their organizations. SDRs will be more comprehensive than the TCFD framework and require more comprehensive disclosures; they will be phased in over the coming years.

United States

- ESG reporting and disclosure remains voluntary for companies. However, a shift to mandatory reporting is expected.
- FSOC recently released their Report and Recommendations on Climate-related Financial Risk in response to President Biden's Executive Order 14030, Climate-related Financial Risk demonstrating their commitment to building on and accelerating existing efforts on climate change through concrete recommendations for member agencies.
- The Securities and Exchange Commission (SEC) has solicited public comments on 15 questions regarding climate and ESG disclosure to determine how it should best promote consistent, comparable, and reliable climate change disclosure and consider third-party frameworks and standards.
- The SEC also plans to update its 2010 guidance on existing disclosure requirements for climate change matters.
- The SEC's Asset Management Advisory Committee recently formed an ESG Subcommittee to explore the necessity to integrate ESG more explicitly into its regulatory framework.
- The Commodity Futures Trading Commission (CFTC) is expected to finalize rules that would codify and standardize climate disclosures for publicly traded companies.

APAC

- Several APAC countries have developed local standards and taxonomies, such as the Green Bond Taxonomy of 2015 in China and the Climate Change and Principle-based Taxonomy of 2020 in Malaysia.
- Country-specific reporting and disclosure frameworks for listed companies have been introduced in several countries, including China, Australia, Malaysia and India.

The Right Tools for the Job

Institutional investors need tools to help in their investment selection process, so that they can understand the ESG implications of their investment decisions and show investors and prospective investors the veracity and rigor of their approach to ESG. Any solution should be able to help users explore and identify the ESG components aligned to their values and goals, how these components are scored and how they can inform and support specific investment strategies and objectives. In a recent BNY Mellon analysis conducted for a client with an international equity portfolio, we identified a need for three separate vendor data sources to provide actual carbon data coverage (as opposed to estimated) for the entire portfolio.

At the same time, institutional investors need a regulatory reporting solution that enables risk managers to meet disclosure and transparency requirements and demonstrates how a fund or mandate performs against its objectives. Any potential solution should streamline compliance (by automatically populating SFDR templates, for example) and take account of evolving regulatory regimes by adjusting formatting and the information provided to accommodate new requirements such as the UK's forthcoming Sustainability Disclosure Requirements and any forthcoming rules introduced by the SEC and regulators in APAC, for instance. Tools to help with ESG investment and regulatory reporting need to be linked and automated to support the management of regulatory exposures and demonstrate that adverse impact factors are progressively managed down, as well as to minimize the back-office burden for institutional investors.

There are many approaches to ESG integration and mitigation and all of them need to be accommodated. For example, some portfolio managers use ESG exclusions that omit fossil fuel producers such as oil companies because of their carbon emissions. Other approaches focused on identifying impact opportunities, for example, might allow investment in such companies because they are committed to changing their business model and expanding their renewable energy production or hold valuable patents for renewable technologies and could therefore be important in combating climate change. Any solution should therefore be customizable to the needs and objectives of institutional investors, so it can reflect their ESG preferences at an individual fund level.

Planning for the Future

The importance of ESG in the asset management world will only grow in the coming years. Climate change and social and governance issues have captured the imagination of many end investors, so it is imperative that asset managers evolve their mindset and processes in order to prosper in the coming years. ESG issues also now dominate political discourse. Momentum for more stringent ESG measures – both for society as a whole and financial markets in particular – will only grow, while regulatory standards continue to evolve in Europe while mandatory disclosure looks likely in the U.S.

To address these challenges cost effectively and reshape their organization for the ESG challenges and opportunities to come, institutional investors need to proactively consider the solutions available, so they can better understand the impact of ESG factors on their portfolios and ensure they have effective regulatory reporting processes in place.

Learn more about BNY Mellon's ESG data analytics and regulatory compliance solutions.

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At BNY Mellon, we're committed to putting the *Future First*℠ by using our global reach, influence and resources not just to power success today, but to help safeguard the future. We aim to accelerate the evolution of ESG – on behalf of clients, investors, communities and all stakeholders – to make a positive impact on people and the planet. For more information, visit www.bnymellon.com/futurefirst.