

Getting the ABCs of ESG right

Takeaways from a webinar conducted by CRISIL Global
Research & Analytics and Greenwich Associates

June 2020



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On June 18, 2020, CRISIL Global Research & Analytics (GR&A) and Greenwich Associates jointly conducted a webinar on building best-in-class ESG practices. More than 350 delegates from the buy-side, the sell-side and commercial banks attended the event.

The panelists were Michelle Dunstan, Global Head of Responsible Investing, AllianceBernstein; Gail Glazerman, Sector Lead – Resource Transformation and Renewable Resources, SASB; Sara Sikes, Principal, Investment Management, Greenwich Associates; and, Chris Perceval, Director, Head of ESG Business Development EMEA, S&P Global Market Intelligence. Dimitri Londos, President, CRISIL GR&A, moderated the discussion.

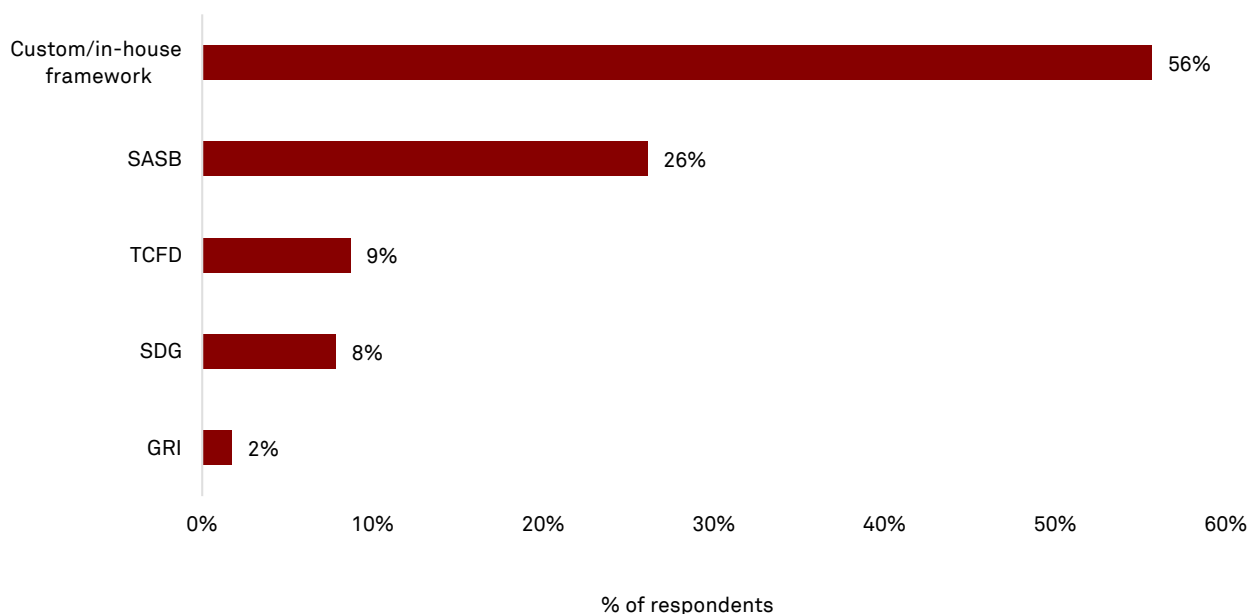
The insights from the webinar, which form a solid foundation for ESG practices, are summarised below:

The building blocks

A. One standard unlikely; leveraging existing approaches likely path; focus on materiality

- **Disclosure levels improve but overall quality lags:** Activity in sustainability reporting is huge: Over 40 stock exchanges globally either have reporting mandates or are considering them. Nearly 85% of S&P companies now issue some type of sustainability reports compared with just 20% in 2011. Governments, too, are considering some form of ESG reporting, a prominent example being the European Union's Non-Financial Reporting Directive. However, investors are dissatisfied with the information they get. Reported data tends to lean towards a discussion of policies and goals rather than quantified metrics.
- **Materiality frameworks can provide insights on the future and enhance engagement:** The panel concurred that a key challenge with current frameworks is they are backward-looking. However, if the framework is built on financially material parameters and is evidence-based – for example, based on the Sustainability Accounting Standards Board's (SASB) framework – it can provide valuable inputs and become relevant for engagement with companies. For instance, companies could have used the existing information to derive insights and engage during the Covid-19 pandemic.
- **Convergence of standards doubtful, but there could be compatibility:** The existing frameworks and standards serve different purposes and stakeholders. Hence, convergence to one standard may not be practical, but there could be compatibility. There are many initiatives such as the Better Alignment Project, where standard-setters are engaging with each other to understand just this. They are attempting to identify areas where standards convey the same information but in different reporting formats. The idea is to elicit interconnections, overlaps and mappings among frameworks. Ultimate acceptance, however, will depend on the priorities and focus areas of investment managers.
- **A building block approach using existing frameworks is imperative:** There is a need to leverage existing standards and frameworks to address the requirements of different stakeholders. It would be prudent for governments and regional regulators to use existing standards as the building blocks instead of each geography or country establishing its own requirement. The views of the panelists were mostly in line with the results of our live survey during the webinar – nearly 55% of the respondents were looking to adopt a customised framework (see chart below).

Which ESG framework do you have or plan to adopt? (Select any one)



SASB = Sustainability Accounting Standards Board; TCFD = Task Force on Climate-related Financial Disclosures, SDG = Sustainable Development Goals, GRI = Global Reporting Initiative

Source: CRISIL GR&A webinar poll, based on 125 responses.

B. Engage in active ESG research, improve signalling and data strategy for ESG integration

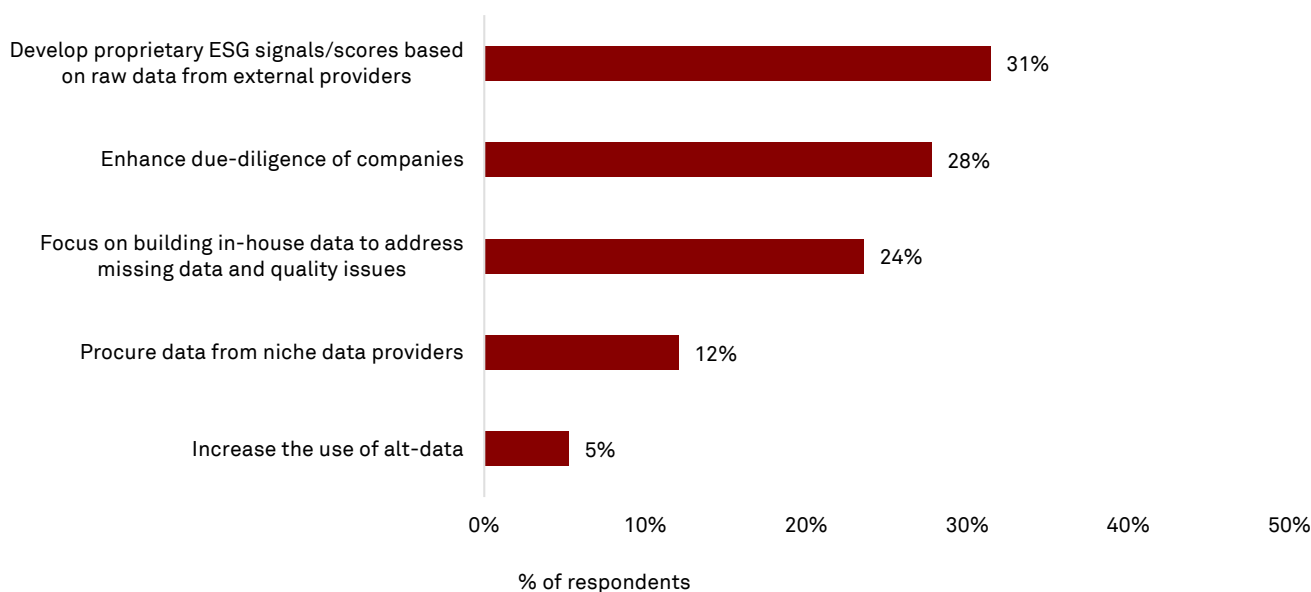
- No easy answers to missing-data challenges; need to leverage industry, secondary, and alternative data:** Investors can source data broadly from public data sources (government databases and consultants); managements; and, industry-specific databases (for example, on carbon emissions from airlines). There are new datasets on Sustainable Development Goals (SDGs), climate physical risk, portfolio alignment with the Paris Agreement, and ESG scores. The SDG dataset measures the alignment of a portfolio with the 17 globally agreed goals for sustainable development by considering the positive impact of products and services, and the risk exposure due to negative footprints. New third-party ESG scores datasets leverage private and public data derived from corporate sustainability assessment questionnaires.
- Financial institutions could combine environmental performance with financial metrics:** This is to ascertain impact on the balance sheet and credit scores. Banks with very large and diverse loan books may apply useful proxies such as the location, primary sector and revenue break-up to determine climate risk hotspots within a portfolio. For instance, a Nordic asset manager (AM) was able to pinpoint its portfolio companies most exposed to physical risks from climate change, and then drill down into which specific operations and infrastructure these companies were most at risk.
- Engagement with companies essential to bridge data gaps; responsible investing teams need to complement analysts:** The responsible investing team needs to help analysts gain a deeper understanding of ESG issues. It is useful to have a materiality map or a framework similar to that of the SASB to identify the most important issues in a particular sector and link these directly to financial impacts or outcomes. Investors need to talk to the management and understand how ESG issues will evolve in the future. On the

engagement front, it is much more powerful if investment decision-makers ask CEOs and board members tough ESG questions that will potentially change their behaviour on ESG issues.

- **ESG integration is hard, requires active research:** Active managers find it hard to achieve proper integration and data shortcomings have to be overcome with active or on-ground research. Third-party ratings provide a good starting point, but they are backward-looking and the single numeric rating does not provide the nuances of company-specific ESG issues. AMs need to adopt an investor-driven model in which analysts and portfolio managers are at the centre of the integration process. Investors ultimately own the investment decision and they need to fully understand and embrace the impact of ESG on their portfolio returns and outcomes. Analysts need to talk with the management team to understand how the company is going to evolve. Analysts will also need to determine the financial impact of ESG issues and incorporate them into cash flow, earnings or credit models.

Overall, the views were of the panelists mostly in line with the results of our live survey conducted during the webinar – nearly 80% of the respondents were looking to focus on developing proprietary ESG signals, enhancing due-diligence and building in-house data to address missing data issues over the next 1-3 years (see chart below).

Among the following ESG strategies, rank your firm’s likely priorities over the next 1-3 years? (select any three)



Source: CRISIL GR&A webinar poll, based on 102 responses.

C. Asset managers need to focus on track record, narrative and ESG credentials

- **Asset allocators are looking for a cohesive narrative, systematic integration and commitment:** AMs seeking to meet evolving investor demand must develop a cohesive, genuine narrative on the company’s ESG philosophy; proactively discuss this narrative and approach in meetings with clients, prospects, and consultants; consider ways to systematically integrate ESG factors into the investment process (versus offering exclusionary screening products or the like, which are now less in vogue among institutional

investors globally); and, stay attuned to the evolution of E, S and G issues and stay committed to pivoting their approach or positioning (where appropriate) to stay relevant.

- **Demonstrate the track record and ESG approach to inspire confidence among asset allocators and consultants:** As ESG becomes integral to the portfolios of institutional investors, measurement frameworks and benchmarks will become more important. True benchmarking or performance is an outcome metric that investors care about. To date, they have trouble quantifying performance because of different ESG approaches of managers.
- Asset owners are increasingly relying on consultants that have begun to incorporate ESG scores for managers into their research and due diligence framework. Investors and consultants are not showing their cards on how much they care about ESG, and they are waiting to see whether the manager brings it up. This is used as a gauge of the manager's commitment to ESG.
- **It is easy to answer in the standard language about the firm's philosophy:** But managers who are proactive about discussing it in each meeting as an integral part of their process and philosophy will have an advantage over the competition. To meet ESG scrutiny, AMs need to focus on having a track record to prove positive outcomes against a suitable benchmark; and, solid explanations about how they approach ESG as a key element of the investment research function for all decisions.
- **Need to balance between ESG-labelled strategies and integration:** While the increasingly preferred approach is ESG integration, there are still some asset allocators who might prefer a specific investment in an ESG-labelled strategy as a way to fulfil an investment guideline on the topic. Over time, investors will become more comfortable with the integrated approach, but for now, there may still be demand for ESG-specific products.
- **Factoring in 'S' crucial, especially given the pandemic and the Black Lives Matter movement:** Historically, the 'S,' or social factors, have been the hardest to quantify and therefore received the lowest priority. Given the societal impact of the pandemic and the gaining prominence of the Black Lives Matter movement this year, there has been a heightened focus on the 'S' elements – both in terms of investment opportunities and AM responses. There are anecdotes of investors leveraging the data science team to focus on pandemic and its intersection with social and governance (S&G) factors. They are also using web scraping of review sites and social media to understand business resilience and employee treatment. Companies that get high scores from their employees on how they and their executives handle S&G factors can attract and retain talent better. In the long term, such factors also affect how companies perform better.

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