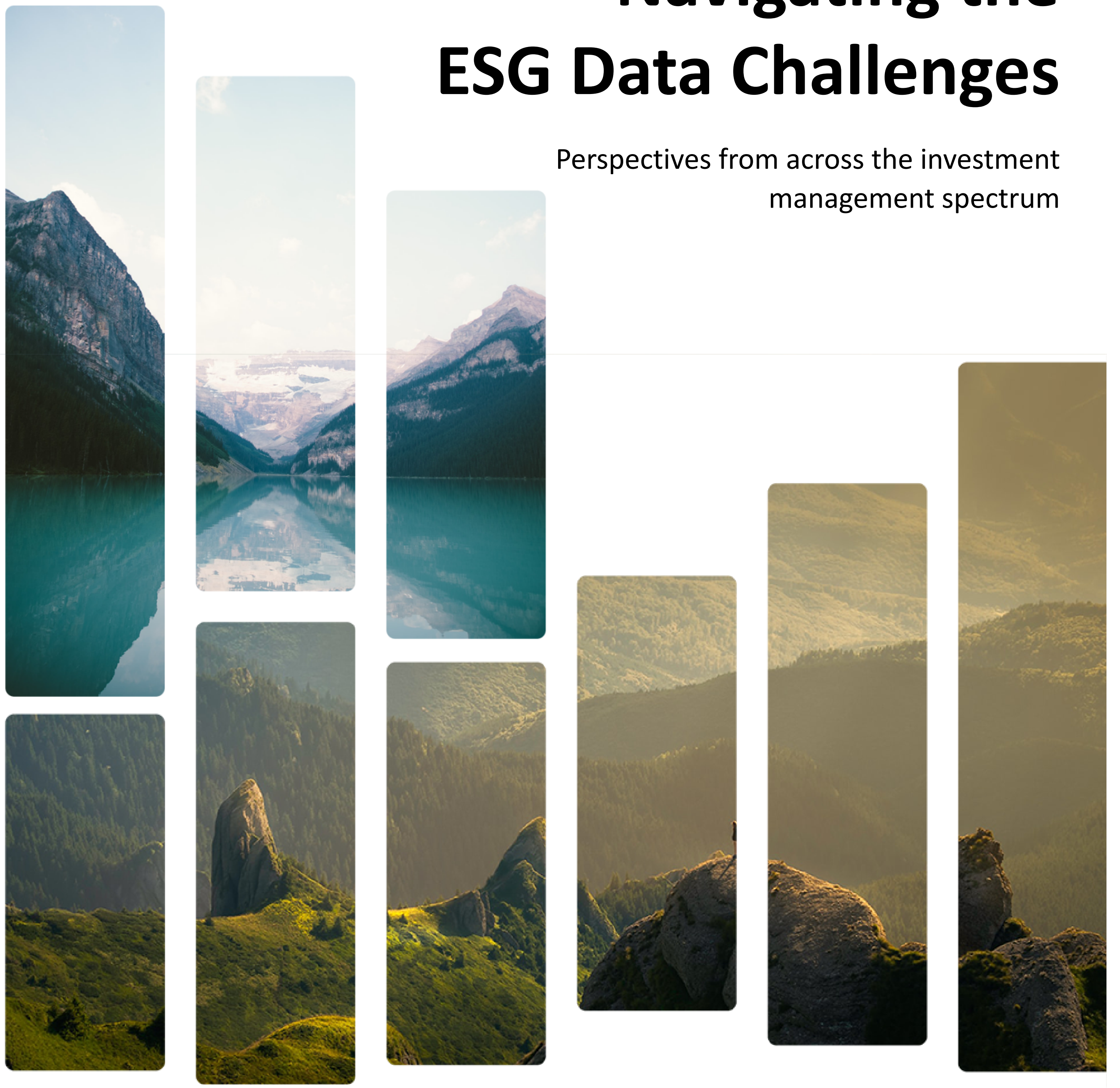
Navigating the ESG Data Challenges

Perspectives from across the investment management spectrum



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Navigating the ESG Data Challenge
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ESG investing is in full swing in 2023. According to a poll of 184 institutional investors* in 2022, 86% have implemented sustainable investment strategies into their portfolios and the number of participants is only growing. Furthermore, the number of ESG standards is also increasing, and EY estimates that there are more than 600 ESG frameworks and standards today.

This poses a challenge for investment managers who have to interpret regulatory standards and anticipate future changes, as well as build and manage reliable ESG scores formulated from the massive volumes of data made available via vendors and proprietary research.

As a data management solution provider with a focus on ease and simplicity, Fencore has made navigating this landscape one of its priorities. Here, we would like to share a quick overview of the challenges in the industry we have learnt from working with asset managers both large and boutique, and hope that you'll benefit from our findings.

Part 1: ESG Industry Issues

Data vendors and regulators make up a big part of the ESG environment which asset managers have to operate in. Here, we explore the industry and its implications on decisions that asset managers must make.

| 1 | Evolving regulatory definitions

Upcoming definitions of sustainable investments by regulators remain unclear. A prime example is with the EU's Sustainable Finance Disclosure Regulation (SFDR) and the UK's Sustainable Disclosure Regulation (SDR). Due to this, asset managers are caught in shifting sands and are struggling to make decisions that may impact the classification of their holdings, as well as the international distribution of funds, with total clarity.

| 2 | Preparing reports through change

Evolving regulations also come with changing reporting requirements. Today, asset managers must transform their data to accommodate a variety of reporting standards, sometimes through spreadsheets or manual work, and have to maintain reporting accuracy even as their internal ESG formulas and regulatory reporting standards change.

| 3 | Prohibitive costs of ESG data by ratings providers

Data subscriptions have always been expensive in a market with few trusted providers of fundamental financial data, and it is no different with ESG data. MSCI, Sustainalytics, Bloomberg, S&P, Refinitiv, Matter, RepRisk and a handful of others remain the top vendors of choice and costs remain high. High costs mean that boutique fund managers are being priced out altogether, preventing them from retrieving ratings from these agencies.

*FTSE Russell global asset owner survey 2022

| 4 | Lack of coverage of mid-cap and small-cap companies

Portfolios of both boutique and large asset managers often include holdings in mid-cap and small-cap companies that can bring significant returns. However, smaller companies struggle to meet ESG reporting requirements and therefore rarely show up on ratings data provided by vendors. The only way to provide a rating is to conduct proprietary fundamental research and analysis, which can be time consuming and expensive.

Part 2: Operational Issues

As firms advance on their ESG journey, the fee pressure and challenging market conditions mean management is not keen on writing blank cheques for ESG data sources. Consuming this data efficiently to feed all the internal use cases is paramount. Let's delve into the main challenges we have heard about.

| 1 | Time-consuming manual collection of ESG data which is stored in spreadsheets

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More than 50% of companies store their ESG data on spreadsheets today, and there is resistance to moving away from spreadsheets, considering the logistical burden and costs of transferring their operations to data management systems, as well as the high costs of data management software in the market. However, there is also an invisible cost and risk associated with relying on error-prone and time-consuming manual work, creating, and maintaining macros. By avoiding the visible costs, fund managers are taking on these invisible costs and risks instead.

| 2 | No single ratings provider has full coverage of all aspects of ESG

The common methodology for ratings providers to create their ratings is to derive a score from a selected list of metrics, or if they are using a larger number of metrics, assign them into categories for calculating a final ESG score. Due to this selection process, no single ratings provider provides coverage of all metrics including carbon emissions, diversity and inclusion, labor relations and others.

Filling the gaps relies on paying for, and consuming data from, a growing number of ESG data vendors and taking on the technical and analytical challenge of combining and making sense of the data in a holistic manner in order to create ESG scores. Which leads us to the next two points below.

| 3 | Low agreeability of ESG ratings from different providers

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A single source of ESG data is insufficient as the risk of greenwashing is too great, and will not fulfill regulatory requirements, particularly for Article 8 or 9 Funds (SFDR).

As there is a considerable amount of subjectivity in assigning ESG scores, together with opaque methodologies by the ratings agencies, there is often a significant lack of consensus between the sources. In fact, ESG scores across six of the most prominent ESG ratings and scores providers correlate on average by only 54 percent. Therefore, retrieving multiple third-party opinions is advisable to gain additional confidence that an investment truly has the green credentials it espouses.

| 4 | Data management and workflow issues

Unlike fundamental financial data which is considerably more standardised, ESG data requires the overlay of further processes to consume and aggregate data from multiple sources and house them in a single unified platform alongside financial data. This can result in users browser-tab switching between different ESG point solutions in a disruptive workflow.

| 5 | Corporate issues

Lastly, large organisations can also get in their own way. In light of a changing ESG regulatory environment, asset managers have to scan the horizon in order to pre-empt future regulations and prepare data warehouses appropriately. Both management structures and data management technology have to remain nimble in order to adapt quickly.

Risks will increase if an investment manager requires data attributes or metrics not currently provided by the rating agencies, or if data management systems are unable to deliver data that meet regulatory reporting requirements, and may result in fines, restrictions on distribution, or accusations of greenwashing.

Part 3: Overcoming the challenges

| 1 | Store manually sourced ESG data in an audited system

If prohibitive costs prevent your firm from purchasing ESG ratings, the next best approach is to store the data cost-effectively inside a secured and audited system. This means you benefit from a transparent audit trail that can show you how your internal research affected your investments' ESG scores over time.

| 2 | Calculate an internal ESG score

Instead of relying solely on the scores of your external ESG data sources, calculate an in-house score made up of weighted averages from your chosen sources. This helps put your company's stamp on the methodology, whilst considering all available data. The benefits of calculating an internal ESG score can be maximized by ensuring that all source information is easily accessible, and that the aggregation formulas and level of agreeability of data sources are made available to all stakeholders on a security, company and portfolio level.

| 3 | Build a unified data platform to house your ESG data

Instead of hopping between ESG point-solutions from individual ratings vendors, automate the feeds of data into a single data hub. This mastered data will become the single source of truth for your ESG data. Even better, house your other masters such as portfolio, legal entity, position and security master etc. alongside this ESG data to supercharge your operations, and allow for flexible report generation for regional taxonomies and regulatory requirements.

| 4 | Prove to regulators you have done your homework

As more and more ESG-related standards and reporting move from mere guidance to requirements, it is important that asset managers can prove that they have been diligent in managing the myriad sources and attributes of ESG data. Investment managers must consider not only the regulations in their home market, but of any region where they wish to distribute their funds.

Instances of greenwashing will have serious reputational risks, and allegations have already begun hovering over the industry. Conflicts of interest can arise when agencies are paid to provide ratings. Ratings providers may be pressured into giving desirable ratings that are being sought to give the seal of approval to a sustainable fund.

This same thing happened with credit ratings leading up to the Great Financial Crisis and taking the right steps now to avoid a repeat of history with ESG data makes strong business sense.

| 5 | Move forward with digital transformation

It is perhaps more important than ever to stress the importance of digital transformation in these changing times. With the rapid advancement and proliferation of technologies that aid the finance industry in the past decade, it is now a critical, cost-saving exercise to enhance business operations with software such as Fencore's SaaS data management offering DataHub.

Improved technological capabilities mean fund managers will be able to navigate the ESG landscape as it evolves in the years ahead and investing now will help drive sustainable growth.

We hope that our list of ESG data challenges has been helpful to you and perhaps you are inspired to improve your firm's operations. To find out more about how a data management platform can help with your ESG data challenges, speak to us at info@fencore.co, or visit us at our website at https://www.fencore.co