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Getting to grips with ESG reporting

EUROPE MAY BE AHEAD ON ESG REGULATION, BUT THE US IS ALSO MOVING FAST. CHALLENGES TO ESG REPORTING CAN BE OVERCOME BY USING AN INNOVATIVE ASSET SERVICING PROVIDER, SAYS MIKE MCCABE OF MUFG INVESTOR SERVICES.

THE MOVE TOWARDS environmental, social and governance (ESG) investing is accelerating fast as regulators take actions – most notably in Europe with the European Union's Sustainable Finance Disclosure Regulation (SFDR).

The regulation, which came into force on March 10, is seen as a gamechanger for tackling ESG reporting and transparency and will likely have a knock-on effect on other regulatory regimes. It applies not only to EU financial market participants but also to those outside Europe that market their products to EU investors.

Mike McCabe, Chief Commercial Officer at MUFG Investor Services, part of Mitsubishi UFJ Financial Group, says the SFDR is the first real regulatory step to address the lack of transparency in ESG investing, and has generated a lot of interest outside of Europe.

"If we look at the global landscape right now, Europe is definitely ahead of the US in terms of regulation and taking ESG seriously in recent years," he explains. "The initial requirements of the SFDR had not been as fleshed out as most people would have hoped, which resulted in the regulation being implanted in two phases, level 1 and level 2, with the second set of rules coming into effect in 2021. This leads to much more onerous reporting requirements being imposed on managers where the availability of that data is going to be a challenge".

He believes that SFDR can be a "blueprint" for other areas and regimes to adopt and predicts it will become the *de facto* ESG standard in multiple jurisdictions.

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Mike McCabe

While Europe is clearly ahead in terms of ESG regulation, there are other factors at play that are driving the momentum among asset managers outside the bloc – including demand from investors.

US managers adopt ESG

In the US, for example, there has been a huge inflow of investments into ESG from both institutional and retail investors.

"Managers in the US are leading on this rather than the regulators," says McCabe. "City and state pension plans in the US are focused quite heavily on

ESG now and are adopting it very quickly to focus on what their investors and constituents are looking at, especially around climate change, diversity and social responsibility. So, managers in the US are being led more by demand from their investors."

US regulators and policymakers are also taking ESG much more seriously under President Joe Biden's administration. The Securities and Exchange Commission (SEC) has taken multiple steps recently that demonstrate a clear emphasis on climate and ESG-related investing and created a 'Climate and ESG Task Force' within its Division of Enforcement. The SEC also recently issued a risk alert which is causing managers to really focus on their frameworks.

Under the previous administration, the Department of Labor introduced controversial rules for investment duties and proxy voting that make it harder for US pension funds to select ESG funds for retirement plans. However, the department has said it will not enforce this policy.

McCabe says: "We're starting to see a step back from the contentious issue and more alignment, and there is greater focus from the new administration on climate change and infrastructure as well. But while the new administration has put climate change at the forefront of its policy, the extent of the impact of the change in administration still remains to be seen."

Meeting the challenges of ESG data

The lack of standardisation when it comes to data presents a challenge for asset owners and asset managers when reporting on ESG.

For example, under SFDR, they must disclose the adverse impacts of investment decisions on sustainability factors. To meet this requirement, they must be able to see the ESG implications of every asset, which is a significant data management minefield.

Understanding and getting clarity on how each of their investments should be classified is probably the biggest ESG hurdle for asset owners and asset managers, says McCabe.

He explains: "The challenge for asset managers is figuring out how to maintain and gather the ESG data to be able to comply with the SFDR. For asset owners such as pension funds which have multiple investments across multiple managers, their challenge is to drill through a portfolio and look at what is exactly held in that portfolio. It takes a lot of effort to talk to a manager in order to understand the investments, and also the impact and intent of those investments."

There are a multitude of data providers that produce ESG scoring on various investments, and the underlying models to produce ESG scores can vary significantly from provider to provider. Some scoring providers are more focused or have greater expertise in one area than another, which makes it difficult to pick between them.

MUFG Investor Services looked at whether there was a way to aggregate ESG scores and display just those that were most applicable to a client's investments.

In March 2021, the team at MUFG Investor Services launched a transparency report to help its clients better understand the ESG quality within their portfolios as they seek to integrate ESG data into portfolio analysis.

This solution, which was developed through discussions with clients, provides investors with transparency on how their investments perform in line with ESG characteristics.

"We can do the qualitative analysis, calculate an average score across a number of providers, and then produce reporting – essentially giving the asset manager or asset owner a one-stop shop," says McCabe.

The reporting tool maps ESG data to a client's portfolio, providing a top-level portfolio rating, highlighting top and bottom performing positions. Additional analysis is also provided based on sector, asset class and other metrics, and covers both public and private markets.

Unsurprisingly, ESG data collection and analysis are hardest in private or illiquid markets. McCabe says the most difficult part is being able to drill down into portfolio companies.

To help institutional investors, fund-of-funds managers and general partners investing in private equity, venture capital, private debt, infrastructure and real estate, MUFG Investor Services launched a private markets ESG reporting solution in April 2021. The tool allows data to be collected in an automated way, with an overlay of ESG expertise from analysts, while tailored to clients' needs.

ESG will be ingrained in the market

The momentum around ESG is moving fast, and any market participants that do not come on board risk being left behind.

MUFG Investor Services' parent company, Mitsubishi UFJ Financial Group, is aligned with the UN Global Compact initiative, the Taskforce for Climate-related Financial Disclosures, and Climate Action 100+, which McCabe says, "shows our corporate commitment to ESG and sustainability in general".

The group also strengthened its commitment to ESG by hiring a Chief Sustainability Officer last year, who also sits on the Board of Directors.

McCabe concludes: "Ultimately, I think every firm or institution will have to make an ESG statement about what they are, who they are and where they are going.

"In the long-term, ESG will become ingrained in the market, and this will lead to improved reporting and transparency."