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Governance of Sustainability Dialogue - *From Climate Change to Social Change*

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Plenary 7: Optimising Sustainability Ratings and Data

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- Brendan Sheehan, Vice President - Senior Analyst, ESG, Moody's Investor Services, US
- Peter Mennie, Global Head of ESG Integration and Research, and Global Head of Investment Risk & Quantitative Analytics, Manulife Investment Management, UK
- Chair, Janine Guillot, CEO, SASB, USA

Janine Guillot:

We have a terrific group of panellists. When we educate companies about integrated reporting framework and SASB Standards, we lay out the landscape. There's massive confusion and conflation of raters, rankers and standard setters. There are three buckets: voluntary frameworks and standards for company information disclosure into the public domain, which is most analogous to traditional financial accounting standard setters. But unlike traditional financial accounting, this space is generally voluntary. The next is data aggregators: organisations like Bloomberg or Refinitiv, aggregating multiple source data, providing investor access. Raters, rankings and analytics providers, like MSCI, Sustainalitics, take that data, producing scores, rankings, ratings.

There's some overlap between buckets but clarifying them helps companies understand the landscape. No-one conflates or misunderstands S&P's role in credit rates versus IASB or SASB in accounting standard setting, it's well understood. MCSI and SASB's roles are always conflated. The ecosystem is not mature and well understood. We're moving towards it, but it needs solid foundation underpinning, of generally accepted disclosure standards, feeding the ecosystem with high quality, comparable, reliable, consistent data.

Our panellists will discuss how they use the ecosystem's components, and to Ruchi, where she sees it going. Peter, how are ESG scores used in your investment process, and the various tools for different purposes?

Peter Mennie:
Manulife incorporated ESG into our global Investment Team process, because well managed, sustainable companies are better positioned to deliver good risk/reward profiles for clients, with their mindset, identifying opportunities, investing capital appropriately for the future. Sustainability risks manifest as tail risks, permanently damaging clients' wealth.

We buy data from various providers, such as those you cited, and the buckets you discussed. When evaluating data, it's important to understand what it represents and its alignment with our aims. Credit ratings have been around for decades. There's a wealth of data, a very clear target, modelling one thing. Substantial analysis can show how well it predicts the outcome. ESG data has evolved. Due to the work of SASB, etc., new data is available. Aggregators and scoring providers incorporate it, and scores and datasets have naturally evolved, but you must understand what the data expresses.

We encourage our Investment Teams to take a high or low ESG score, dig into it to ask what it means, what's driving it, and what it says about the company. SASB's materiality map is used to identify what's most important for the sector, to prioritise research, and drill into the data.

We expect the world to keep changing. We extensively train Investment Teams on things like climate change, a huge focus in recent years. We expect this to continue. TNFD has just launched. By 2023 it should have a framework. More data will emerge on biodiversity, etc. Scoring providers should continue to update methodologies to incorporate this and investors will research it to understand the good and bad, how it relates to companies, materiality, etc., and how we should react. We're building resilient portfolios with a good risk/reward profile and applying it to the investment process.

Janine Guillot:
How do you see that through the lens of product and strategy, particularly impact type products, vis-à-vis those marketed as general ESG integration products? Is data used differently?

Peter Mennie:
Absolutely. Clients seek a spectrum of outcomes. Some have sole focus on financial outcome, risk/reward profile of investments. Some want to balance it against sustainability outcomes. We anticipate making a positive environmental impact, even for those seeking good financial risk/reward profile, because of our extensive Stewardship Programme, we want companies to improve disclosure and actions, reducing carbon emissions, etc. The types of data for different clients varies. A sustainable outcomes client has different data and portfolio creation will be different.

We aim to achieve a low carbon planet, not portfolio. It's easy to window dress a portfolio, tilting it from highly polluting sectors to those not committing much carbon, to increase scores. We want to encourage change by investing in a diversified portfolio, researching sector leaders and understanding their actions, encouraging other companies to lead. As new sectors emerge, with solutions, we can differentiate between companies and apply the knowledge. We see now how to move to a low carbon, Net Zero economy. Other sectors, e.g. cement, must evolve, so we can differentiate between companies and invest in lime. We encourage companies interested in pursuing Net Zero.

Janine Guillot:
Very helpful. Brendan, the ESG conversation originated in equities, where there's tremendous focus. How do you view ESG integration and data use through the credit lens?

Brendan Sheehan:
ESG through a credit lens is interesting. It's inaccurate that ESG is new to the credit world, but credit rating agencies are fairly new to public conversation around it. Most major agencies have been consistently involved publicly for 5-6 years.

Moody's has always done ESG. Accurate credit ratings can't be issued without thinking about company owners, how they exercise control, the supply chain risks, their vulnerabilities to regulatory action, impacting their cost of cleaning up spills or access to raw materials. Our Analysts always did this, but didn't always publicly discuss and flag them as ESG risks. They were rolled into company day-to-day business risks.

Most companies understand ESG. It hasn't always been in an ESG bucket. I spend significant time with CFOs and Corporate Treasurers discussing impacts of incremental supply chain risks all day. It's not new to us. Moody's activities around ESG don't make overall commentary on corporate citizenry. Our focus is credit materiality of various ESG elements of specific sectors and companies. Our scores are very different to familiar scores in the public domain, because they're purely credit materiality focused and we're not commenting on corporate citizenry. Credit ratings, as a prediction of loss, given default and probability of fault, have always been forward looking, as are our ESG scores. We consider previous behaviour, but our focus is forward looking ESG assessment.

Moody's take a four-step approach to ESG. We published broad reaching methodologies, free to the public, with detailed descriptions on our view of ESG and its definitions for corporate, sovereign, and various other audiences we rate. We have environmental and social heat maps, looking at exposure of different sectors to E&S risks. Governance risk is similar for almost every company and sector, so we have no heat map. Some companies have heat stress or water risk, others don't, but in general, everyone has governance risk exposure.

Our published scores are Assured Profile and Credit Impact Scores. IPS examines a company's degree of ESG risk. CIS is the degree of credit rating impact from the exposure. Cement companies are highly exposed to environmental risks: carbon, water, etc., but with no concrete substitute, the risk may not currently manifest in credit ratings. Hence, the two types of risk.

Credit rating agencies are familiar with credit opinions. We have detailed descriptions of their company-level manifestations into overall credit ratings. We identified and published 15 broad ESG risk areas, five in each, which are material to credit under most circumstances.

ESG risk can be positive and negative. Some companies position themselves well to take advantage of future emerging environmental risks, solving environmental problems, social risk. There's more downside risks, but for these, we give positive ESG scores, where appropriate.

Janine Guillot:
People do think credit rating agencies are doomsayers.

Brendan Sheehan:
Maybe, but we try to be balanced.

Janine Guillot:
Your explanation around exposure and impact on creditworthiness was interesting. One of the main frustrations from companies more than investors, is the lack of correlation across ESG ratings. A gives a high score, C gives a low score, they know how to manage and influence credit rating, but can't determine how to influence ESG rating. Could there ever be more ESG rating consistency? If not, how do companies manage?

Brendan Sheehan:
Yes, we've already seen it. In my 20 years, various scores, standards and providers have come and gone. There is some coalescence around global standards and definitions. Your organisation, amongst others, is heavily involved. Cohesion around defining issues and problems is always helpful. We're seeing that already. By market standards, it's a relatively new trend. Equity and credit impact of ESG publicly is maybe 15-years-old. We have a century's data on the accuracy of data agencies' scoring. Scores can be tracked, day-to-day, from 1920s to today, giving great understanding on accuracy.

With more public data, the marketplace will discount and exclude unhelpful information and there'll be refinement of measurements and understanding of the impact on risk. We must understand what the ESG score is saying. The confusion is due, in part, to lack of transparency. Moody's and many of our peers, have been extremely transparent around what and how we measure. There's published methodology of the questions we answer, how they're weighted, all the math, which doesn't always exist in other providers. There may be more coalescence around acceptable standards and scores, but the onus is on everyone. Investors must understand how to use scores and communicate how and why it's needed. Companies need to understand how their disclosures add value to investors and Risk Analysts. This is starting to happen.

Janine Guillot:
Peter, will we ultimately coalesce and surround ratings and scores?

Peter Mennie:
We may, but it'll take time. Thinking of sustainability as a range of things, say the UN SDGs are the range, climate change has reasonably good company data, which reasonably accurately reflects the problems. In other areas, some data is somewhat or extremely relevant. As standards improve, we'll see more data emerging designed to address sustainability areas overall. Climate is the model for other sustainability areas, where standards will evolve, giving us data, which fully addresses it. There's good data on gender, in board diversity, but it isn't measured as well in other areas. It will gradually evolve.

Regarding providers' scores, companies must understand that providers have scores for different reasons, as Brendan set out. When companies ask what to do about their scores, we tell them to look across the sustainability range and understand how it applies to them and what they're doing, expressing it through CSR reports, etc. As it evolves, it will improve ratings. Companies shouldn't see ratings as objectives and try to maximise them. They will change over time. In five years, the methodology will not be the same. With biodiversity, companies trying to maximise their rating by how it's calculated today, is a mistake. Think about your business activities, your behaviour and it will affect your ratings positively.

Janine Guillot:
I always say not to chase ratings, communicate business strategy and performance. When people look at index construction, scores, and boards get scores, it's complicated. Ruchi, disclosure standards are the bottom level of a very complex ecosystem. What are your views on the evolution of the sustainability standards landscape?

Ruchi Bhowmik:
From a foundational element of the current situation, following Professor Edman's Alice in Wonderland analogy, mine is the rabbit running around, late for an important date. In the broader ecosystem we have global standard setters with the same sense of urgency. It's unprecedented in terms of dynamism. Before these sessions, I look at clips to check latest developments. IOSCO made an announcement yesterday on ratings and transparency, joining many global standard setters seeking to create greater clarity, transparency, and consistency. The EU CSRD proposal, of the sustainable finance package, is following the IFRS proposal around an International Sustainability Standards Board.

It's created greater urgency for other standard setters and, last week, the SEC's RegFlex Agenda announcement declared their intention to release something. Gary Gensler mentioned metrics this week, but in October, something will happen around climate and human capital disclosure. They're setting ambitious agendas and schedules to accomplish, with IFRS/ISSB aiming for mid-2022 release, EFRAG in EU aiming for October.

The previous panel said there wasn't a need for regulatory action, but as Head of Public Policy and a former Advisor to President Obama, working with investor groups and Risk Management Teams at a Fortune 50 company, one element regulators will respond to is inefficiencies in the marketplace. Ashley Alder said yesterday, "Global investors need global comparability." The movement is towards, hopefully, greater investor clarity, with stakeholder and shareholder capitalism. The marketplace would benefit from greater consistency, clarity and transparency.

There is an urgency. Investors bear responsibility in understanding their needs. Ratings agencies do their part. Allowing for smaller players to enter and engage actively and robustly with investors, from a Fortune 50 perspective, having done that, it's a lot of work, with significant entry cost. We need to level the playing field to ensure encouragement of entrepreneurship and innovation, reducing barriers to entry. Global sustainability standards can help to create consistency and eliminate confusion. Some of the best ESG reports may have come from the comms shop. Is it a communications or branding exercise, or investment in sustainability processes and ensuring that the data required is available?

Janine Guillot:
In recent days, I've done many global webinars on IRRC and SASB's merger. The most consistent questions relate to keeping small and medium-sized enterprises from being overwhelmed, and private companies, because most markets securities regulation jurisdiction is limited to public companies, not in EU, but many worldwide. One reason why I strongly support accounting standards. They apply to public and private companies and can be used globally. Industry specificity is essential for small and medium-sized companies, understanding the most relevant issues in their industry gives them something cost beneficial. It's a big conversation globally.

Peter, your view of the state of ESG public data and what you need, please?

Peter Mennie:
The data is improving immensely. It's currently very challenging, with many new European regulations, with SFDR. We need more data to comply, the objective being twin companies addressing sustainability and doing no harm. It should be addressed to be globally workable, as European funds invest in global issuers. The demand for data will be huge. We've seen big advances in climate, etc., and we need that advance overall. TNFD is positive and can help on biodiversity, as important a challenge as climate change, on nature and species loss. Hopefully, there'll be more standards and clear disclosure in coming years.

Janine Guillot:
Brendan, your view on availability and quality of data and your needs?

Brendan Sheehan:
All data is good data, largely. It's an interesting question, we're asked constantly. We've engaged with many companies and investors in recent months. We, among other agencies, occupy a unique place in the financial world, with immense inside information access, which Peter's organisation wouldn't have. We're not a bank, investment group, buying/selling stocks, we're risk assessing, so have significant data access that's not often public.

This morning, in a credit meeting, we looked at a company's peers, all five disclosing a social risk, in different ways, a different denominator, in some cases in completely different units. We ascertained and applied standardisation, but it's challenging. Moody's has senior TCFD representation, we support TNFD. We broadly support initiatives increasing data accuracy and consistency. We need care with regulatory standards, which sometimes have a minimal approach, so people do only that demanded. Sector specific data flexibility is very important. Environment and social issues reporting into one of our rating sectors could be completely different to another. Even within a sector, e.g., packaging: glass, metal, paper and plastic, very diverse groups in a sector, with very different E risks, somewhat different S risks. There's homogeneity, but with variance, still.

We support consistent disclosure, but we need significant nuance and flexibility, which regulators haven't always excelled in. Regulators drive positive change, set basis for what's needed, but we must encourage going beyond and understanding the need for flexibility and nuances.

We don't send companies surveys or buy much data from other providers. Our big internal team gathers data. We've bought significantly astute ESG providers and Vigeo Eiris in Europe, 427, an excellent climate change, sea level rise, heat stress company, is an affiliate, with others in Asia-Pacific. We generate most internally used data. We're not as reliant on outside centres. I spend significant time reading SASB standards, etc., they're all helpful. We're unique in the ecosystem.

Janine Guillot:
We reviewed 20 major company sustainability reports, finding 20 different health and safety measures. Many companies using SASB standards are leading reporters, reporting extensive data. They're not always clear on standardisation benefits. They may be releasing a lot of very useful data, but you don't get credit for outperformance, because you can't be compared to peers. The standardisation benefit is leaders can get credit for outperformance.

As we're discussing how standards become embedded in the accounting and regulatory ecosystem, the traditional accounting world struggles with the industry specificity concept. Accounting standards aren't set this way. Ruchi, can you see the accounting standards regulatory disclosure being able to flex to continue to meet market need for industry specificity?

Ruchi Bhowmik:
A great question. I shared our Future of Sustainability Standards report, released this week, including five key recommendations for businesses to take now. We suggest not waiting for them to become mandatory. One is identify your sector's relevant metrics. We need significant change in our approach to business with mandatory standards, but nuances are critical. Brendan's packaging, the granularity needed to distinguish between what seems like one issue, can be confusing. SASB is well versed here.

It's a very fluid, complicated space. Another recommendation is engaging with standard setters. It's critical to partner with users, issuers and producers, to understand what's needed. We need more conversations around key issues and education. You don't want it to happen to you, because risks are high.

Brendan Sheehan:
That's a great point. When the CEO Compensation Standards were introduced, largely, the corporate community was silent. Some major players didn't engage with the market or regulators and the, eventual disclosure requirement was unsatisfactory to them. If you don't participate in processes, you'll probably be unhappy with the end result. Everyone should say what they need, why and how. If companies have genuine reasons why it can't be done, or should be a different metric, they should speak up. Ultimately, the end product will be more useful to everyone, whether mandatory, voluntary, whatever. It requires everyone participation.

Janine Guillot:
Completely agree. People should be encouraged to engage in standards processes. We need a mindset shift. Every major global company has an accounting policy shop, it's resourced and viewed as a significant function for engaging and influencing accounting standards. This mindset is needed for sustainability standards. It's also true of investors. Companies do engage in accounting policy. Investors historically engage less. Some have strong shops resource, some don't. Investor resourcing for standards development engagement is important. It's a significant cultural shift. Accounting standards and regulatory infrastructure must shift culturally, along with investors and companies around engaging in standard setting.

Do you value assurance of this data?

Brendan Sheehan:
Our organisation has no stance on whether disclosure should be in the financial report and be auditable, because we're capable of it ourselves. Much of our work, reviewing probabilities of outcomes, is predicated on information reliability and credibility. Many companies in recent months have stated paths to Net Zero by 2025/2030, whatever. Without detailed and credible paths, we won't give credit for that. It needn't be traditionally auditable or in financial statements, like accounting information, but needs some credibility and reliability. To some degree, credibility is subjective. With credit ratings, you check a company's commitment to its aims and details and step-by-step information of its path, whether Net Zero or gender

initiatives, etc. We also need credible data on how this gives you better positioning against others. Ratings are relative, so what's your risk against others?

Information must be informative on company position to take advantage of an important trend to them. They decide what, not us. We have no stance on auditability, traditionally, but information needs credibility, supported by data. Visibility on E&S aims and supportive data and information is valuable. It's presentation and auditing and assessment, we currently have no stance.

Peter Mennie:
Agreed. We're more confident in assured data. We shouldn't force assurance processes which stop us hearing management's thoughts, particularly future issues. With companies signed up to Net Zero, what pathways they aim to take to Net Zero, the mix of fuel they feel they need. Many things can't be assured, it's management opinion, but we wouldn't want innovation preventing management sharing their understanding of industry evolution and best practice. We'd encourage data that can be assured.

Ruchi Bhowmik:
One of our recommendations is considering how you instil trust in sustainability reporting. Assurance is one way. The EU's CSRD proposal contemplates limited assurance, initially, with a goal of, ultimately, reasonable assurance. It increases data value, but it's not a key element.

Janine Guillot:
The concept of assurance applies cleanly and neatly to this. Internal control, data quality, aggregation, board governance and oversight. With forward looking information, ability to meet targets, do you see a role for assurance?

Ruchi Bhowmik:
I'm not an Auditor, so tend to be cautious with statements here. Forward looking would be changing the audit's nature. We need actual Auditors for that conversation. Particularly, it's interesting to evaluate the ongoing proposals. Providing marketplace value, is that a component? Audits are different, they're retrospective.

Janine Guillot:
Completely. In some conversations, unreasonable expectations are established through lack of clarity. Board governance is an important component, whether there's sufficient board governance and discussion about the assumptions.