World Transformed

ESG Investing 2.0: Moving Toward Common Disclosure Standards

Ronald P. O'Hanley
Chairman and CEO

STATE STREET.

The following is adapted from remarks delivered by Ron O'Hanley, Chairman and CEO, before the International Integrated Reporting Council on November 7, 2019.

At State Street, we have a simple, focused purpose: helping the world's institutional investors achieve better outcomes for themselves and their stakeholders. We service and manage the investments of large institutional investors around the world such as large asset managers, pension funds, insurance companies, financial advisors and official institutions. All of our clients have either long-term liabilities and investment goals themselves, or manage money for investors with long-term liabilities and investment goals. That long-term perspective reinforces the necessity of understanding the risks and opportunities around ESG issues.

Whether it is climate change risk, poor employee relations or bad governance practices, these are issues that can have a material impact on a company's ability to generate the long-term value our clients need to achieve their investment objectives. For us, ESG is a value-driven imperative, not a values-driven agenda. Over the last few years, we have noticed the question around ESG has moved away from the "Why?" to the "How?" But companies and investors are struggling to agree on the ESG metrics that matter most to investors and how companies can best capture and disclose that information. We see a few recent developments in the industry that give us hope that we might be starting to coalesce around a common set of standards.

The ESG Reporting Challenge

As interest in ESG issues has grown, companies have been increasingly bombarded by questionnaires from the cottage industry of ESG data providers that has emerged. The rapid rise of Corporate Social Responsibility reporting has also given researchers new data sets to study. In 2011, only 20% of S&P 500 companies issued a CSR report; by last year that percentage had risen to 86%[1]. While there is a wealth of data, the question is whether it is high quality, specific and comparable?

Investors face a number of challenges. Most policymakers do not yet formally require companies to report on ESG or climate-related sustainability data. France is the only major country that has made climate risk reporting mandatory (Article 173), although the European Commission and the Bank of England have signaled that climate risk reporting will also be mandatory in the UK and the rest of the continent within two years. Therefore, without specific disclosure requirements, companies can decide for themselves what information they want to disclose to capital markets.

[1] Governance & Accountability Institute. https://www.ga-institute.com/press-releases/article/flash-report-86-of-sp-500-indexR-companies-publish-sustainability-responsibility-reports-in-20.html

Another significant problem is that data providers have different sourcing methods, scoring methodologies and weighting approaches, with varying degrees of transparency. As a result, data quality and comparability are huge obstacles for investors looking to create ESG investment strategies. For example, the ESG research group within our own asset management business compared the data correlation across four major ESG data providers: Sustainalytics, MSCI, RobecoSAM and Bloomberg. Unlike the nearly perfect 1.0 correlation of credit ratings data between Moody's and Standard and Poor's, the correlation across the four major ESG data providers was as low as 0.48[2].

There is also a big gap in the confidence of the data quality between issuers of ESG data and investors. A study by PwC showed that while issuers had a 100% confidence level in the quality of the ESG information reported, investors had only a 29% confidence level in that same data[3]. A separate study by EY showed that only 7% of investors were satisfied by the disclosure of ESG-related risks and opportunities that could affect business models and only 8% of investors felt there was an ease of comparing peer companies based on the ESG data disclosed[4].

But We Have Been Here Before

On the one hand, there is a growing recognition among investors, policymakers and companies that ESG issues are material to corporate financial performance and will grow only more material and urgent, especially with regard to climate-change risk. On the other hand, we are seeing less capital in motion because of investor concerns around these data and reporting issues. That is where the entire alphabet soup of good-faith disclosure groups such as the IIRC, SASB, TCFD, CDP, CDSB, and GRI all have an important role to play in coalescing around a common set of standards, metrics and reporting[5].

While that might seem like a daunting task, it is important to remember that capital markets have been here before. Following the financial crash of 1929, capital market participants acknowledged that they did not have sufficient transparency into companies they wanted to invest in, as there was a lack of high-quality accounting data on company financial statements.

When Franklin Roosevelt accepted the Democratic nomination for president in 1932, he declared his goal of letting in "the light of day on issues of securities, foreign and domestic, which are offered for sale to the investing public."

[2] State Street Global Advisors, as of September 2019.

[3] PwC: "Sustainability Goes Mainstream, May 2014," ESG Pulse, 2016.

[4] EY, "Is you non-financial performance revealing the true value of your business?" 2017

[5] The various organizations working in this space include the International Integrated Reporting Council (IIRC), the Sustainability Accounting Standards Board (SASB), the Task Force on Climate-related Financial Disclosure (TCFD), the Carbon Disclosure Project (CDP), the Carbon Disclosure Standards Board (CDSB), and the Global Reporting Initiative (GRI).

The following year he signed the Securities Act, and in 1934 the Securities Exchange Act, establishing a modern system of corporate disclosure and auditing that was refined over the next decades to include the Financial Accounting Standards Board, or FASB, in the early 1970s. Today with efforts like the Sustainability Accounting Standards Board (SASB), we see a similar effort as companies, policymakers and investors seek to agree on high-quality and comparable ESG data and reporting standards.

Progress on Climate Risk Reporting

Climate risk disclosure has received a major boost with the launch of the Taskforce on Climate-Related Financial Disclosure (TCFD) by Mark Carney, Mary Schapiro and Mike Bloomberg in 2017. More than 900 companies have now adopted the TCFD principles, including State Street[6].

In just a few short years, the TCFD has propelled climate change risks to the top of many company and policymaker agendas. Japanese companies, for example, under the leadership of investors like Hiro Mizuno, the Chief Investment Officer of Japan's Government Pension Investment Fund (GPIF), the world's largest, have gone from being climate risk reporting laggards to leaders, with the TCFD acting as an important catalyst.

The Better Alignment Project led by the Corporate Reporting Dialogue and convened by the IIRC was also an important milestone. Bringing together major standards organizations like the GRI, SASB, CDP, CDSP and the TCFD to examine the alignment between their respective frameworks and metrics with regard to climate change risk was a game-changing advancement in coalescing around common standards.

The project found that 80% of the TCFD's 50 illustrative metrics are fully or reasonably covered by the CDP, GRI and SASB. Those efforts will help drive consensus around standardized reporting metrics[7].

State Street's ESG Scoring Methodology

At State Street, our asset management business has also been focused on addressing the data quality and comparability challenges faced by investors. In 2019, State Street Global Advisors launched its ESG scoring system called the R-factor (R as in responsible investing). The scores are based on SASB's financial materiality framework and draw from the raw data provided by several high-quality ESG data sources as well as governance insights from State Street's asset stewardship team. Global Advisors will be including the ESG scores in their standard reporting to clients in order to give them a better view into the ESG profile of their portfolio holdings. R-factor will be used, along with other inputs, to create integrated investment solutions for clients. The scores have also been used to construct new third-party ESG solutions, like the suite of ESG indexes launched in 2019 by Bloomberg.

[6] TDCF.org, as of January 2019.
[7] www.corporatereportingdialogue.com/better-alignment-project

Lastly, State Street's stewardship team has fully integrated the scores into their ESG screens used for engagement and voting. They share the R-factor scores with portfolio companies to encourage discussions around improving their reporting metrics and ESG transparency.

What the Future Holds

While we are still in the early stages of achieving common metrics and standards, we do believe the industry is making good progress. Technology improvements will help companies better identify and capture financially material ESG data. Engagement with investors will clarify the data, metrics and level of specificity that matter. With respect to climate change risks, we also expect that the efforts around TCFD implementation and upcoming mandatory reporting requirements in Europe will hasten the standardization of measuring and disclosing climate change risks.

While there is still quite a lot of work to do on ESG data and analytics, we believe that ESG is quickly becoming a mainstream focus for companies, resulting in better ESG infrastructure and disclosure. The fact is that we are experiencing a structural shift in the value drivers of company performance. Already in the U.S. and in the U.K., more value is derived from intangible assets than the tangible assets that drove the manufacturing economies of the 20th century.

Technology improvements will help companies better identify and capture financially material ESG data

While a large part of those intangible value drivers are derived from technology advancements and other forms of intellectual property, they also include many intangible ESG value drivers. As automation pushes human capital further up the value chain, how companies are managing their human capital will take on new significance. As the pace of change increases, how well companies can align their corporate culture with business transformation strategies will be a key intangible value driver.

As difficult as it is to measure and manage these new value drivers, they are critical for helping investors understand long-term company performance. Partnering with companies, investors and policymakers to uncover the new metrics that matter is ultimately aimed at promoting a more sustainable and inclusive model of economic growth. At a time of existential threats like climate change and historic disruptions around technology, institutional investors have a key role in guiding capital allocation decisions that will support positive change.

About State Street Corporation

State Street Corporation (NYSE: STT) is a world-leading provider of financial services to institutional investors including investment servicing, investment management, and investment research and trading. With $32.6 trillion in assets under custody and administration and $2.8 trillion* in assets under management as of March 31, 2019, State Street operates globally in more than 100 geographic markets and employs approximately 40,000 worldwide. For more information, visit State Street's website at www.statestreet.com.

*Assets under management include the assets of the SPDR® Gold ETF and the SPDR® Long Dollar Gold Trust ETF (approximately $33 billion as of March 31, 2019), for which State Street Global Advisors Funds Distributors, LLC (SSGA FD) serves as marketing agent; SSGA FD and State Street Global Advisors are affiliated.

For more information, please contact:

Patricia Hudson
Head of Thought Leadership
+1 617 664 2020
Patricia_Hudson@StateStreet.com

STATE STREET.

State Street Corporation
State Street Financial Center
One Lincoln Street
Boston, Massachusetts 02111-2900
+1 617 786 3000

statestreet.com

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Expiration date: 31/01/2021