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DETERMINE ESG MEASUREMENT CRITERIA

Compliance, Risk and Impact: Considerations for the Selection of Data and Metrics

There is a wealth of data available to support allocators with measuring their exposure to all kinds of environmental, social and governance (ESG) factors – from company scores and ratings through to asset-level carbon emissions. What to measure and which specific data to select will depend on each individual need. Whether it's to be used for reporting or disclosure purposes, for integration into a risk monitoring framework, or for a more complex impact measurement programme, getting the right data is key. In all cases, the chosen measures should be relevant, material and transparent. A key place to start is to ensure alignment to your strategic goals, determine the impact of ESG factors on your goals, and understand different stakeholder requirements.

Data Needs

Portfolio Construction

In-house investment teams utilise data on key factors to aid security selection and what-if portfolio analysis.

Voting and Engagement

Engagement is a key lever that investment teams can utilise to help achieve long term sustainable investing goals. Data showing company progress on identified issues is a necessary input.

Investment Monitoring

Manager comparison, risk contributions, ESG performance, controversies monitoring all require strong data coverage.

Regulatory Disclosures

For example, Taskforce on Climate-Related Financial Disclosures (TCFD)/ climate risk reporting requirements at the fund level for regulators and members to track progress.

Stakeholder Reporting

As well as investment risk, stakeholders such as pension members and the broader society want to see more reporting on non-financial benefits over time.

Impact Measurement

Measuring the real-world outcomes of an impact investing strategy is a more focused and often custom task requiring specialist data to generate accurate results.

Metrics and Measures

Determine What You Need to Measure and Who For

It's easy to be bewildered by the vast array of datasets available to choose from. To start with, there have been numerous studies showing a low correlation between ESG scores from different data providers for the same entity, which is not unexpected when different methodologies and models are employed. Then there is also the sophisticated nature of climate risk analysis following the rapid advancement of the underlying scientific models – combined with the shift from using a backward-looking lens to a more forward-looking assessment.

Institutional allocators need to first determine which are the most relevant data points that best measure their sustainability objectives and fulfil their disclosure requirements. For example, if climate risk reduction targets are the top priority, what are the most relevant metrics to measure financed emissions or the physical risk exposures in the portfolio? Plus, what level of drill-down detail is required to effectively communicate to different audiences? And how frequently?

Understanding the full scope of needs is vital before reviewing the different options available. A due diligence exercise is then required on the data providers to understand the different data points and methodologies. Data from different providers (including asset managers) will likely have challenges in comparability – especially across different asset classes. The audiences of this information will help to dictate how the information needs to be presented and explained. Most sustainability metrics are challenging to interpret when viewed solely as a set of numbers, which means that qualitative explanations, including any assumptions, are essential when reporting to stakeholders such as pension fund members.

Acronym Soup

Being Aware of Regulatory Requirements and Industry Standards

What you need to measure as an institutional investor is increasingly influenced by regulatory requirements or industry frameworks. Many are focused on improving the comparability of disclosed data from companies and issuers so that investors gain a more complete and consistent view. Others dictate the selection and calculation of particular metrics to be disclosed at the portfolio or fund level.

For several years now, many allocators in the UK and Europe have either been mandated or have chosen to follow the TCFD recommendations, which has successfully helped to define a common set of metrics and targets to be used to measure, monitor and disclose climate-related risks and opportunities. In the EU we've also seen the significant impact of the Sustainable Finance Disclosure Regulation (SFDR) on asset managers and asset owners – with twists and turns along the way that don't look to be over just yet.

Yet there are other regulations being introduced around the world that have similarities but also variation. These may specify a certain type of carbon exposure/footprint metric to be used over another, or could focus on more qualitative explanations of sustainability measurement that are most relevant.

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Helpfully there are a number of well-supported investor groups and industry bodies collaborating to provide regular guidance and clarity to help translate often complex requirements into something more understandable.

Institutional investors may face challenges beyond data collection when complying with these regulations particularly where it's E, S or G mandate is not climate-focused. While regulations must be adhered to, institutional investors must ensure that their frameworks support measurement of their own sustainability objectives as well, the subject of our previous thought piece.

Aggregate Confusion?

Understanding the Data Challenges and Common Approaches

There is a growing array of sustainability-related datasets available to investors. Some providers generate scores and ratings alongside a range of indicators, flags and quantitative metrics. Additionally for allocators, underlying asset managers will invariably report on key measures for fund holdings, including details of their engagement actions. So besides volume of choice, what are the key challenges and considerations to be aware of?

Let's begin with scores and ratings – they are often uncorrelated from one provider to another and it takes time to understand each model (data sources, estimation processes, factor weightings) that underpins the data. Regulators are responding by imposing requirements for added transparency and consistency in approach. Yet a portion of investors appreciate these differences that exist today and don't want increased harmonisation. It's important to fully understand the output of each model used. Some asset managers have created their own models but others are challenged by the volume of requests from the asset owners that consume resources. Make sure that your requests to managers are specific and streamlined to improve understanding and aid the delivery of what's needed - whether to satisfy regulatory requirements, measure bespoke objectives or both.

An alternative to using a single set of scores is utilising specialist datasets for sustainability topics such as climate risk, nature risk and social capital. These granular views can support regulatory disclosures and provide investors with the detail needed to run an effective engagement program aligned to their objectives.

Then there is the significant challenge for many of incomplete data coverage and the decision on whether to use estimation models to fill gaps. Allocators look for data to measure their total portfolio but will find challenges in accessing suitable data for all asset classes – particularly for private markets. But data availability in the market continues to improve. In the interim, many leading investors and regulators encourage the adoption of a "best efforts" policy, adjusting as and when improved options become available. Look to use the best available data to measure and monitor your progress over time.

Keeping on your Toes

Adjusting to New Standards and Areas of Focus

The range and quality of data available to use is evolving at a fast pace. Established financial data providers and newer technology-led fintech's are introducing enhanced data collection techniques to improve quality, range and frequency. Portfolio measurement criteria may initially be set based on an understanding of what's available at that point in time. But when new data solutions and measurement tools are introduced, the measurement and monitoring criteria should be re-evaluated.

Current investor priority remains centered on measuring and reporting on climate risks and opportunities, largely driven by regulatory focus and net-zero targets. But even in this relatively mature sustainability sub-category, there is continuing change through new and evolving risk models and forecasted scenarios. For example, updated scientific assumptions lead to new climate scenarios, resulting in the need to be aware of changes in framework guidance and recommendations that may lead to existing measures requiring updates.

But around the corner, there are also other sustainability topics requiring the attention of allocators. Notably, the integration of nature or biodiversity risks into a monitoring program and the additional disclosure of information to stakeholders. The Taskforce on Nature-Related Financial Disclosures (TNFD) published its final recommendations in 2023, leading to more than 400 organisations in more than 50 jurisdictions committed as early adopters by mid-2024.

These examples highlight how sustainability-related measurement and monitoring requirements continue to evolve and grow. The good news is that there is a consensus among investors and regulators to apply consistency and simplify efforts across jurisdictions to create a clear global picture for all. The development of the International Sustainability Standards Board (ISSB) as part of the International Financial Reporting Standards (IFRS) Foundation is viewed as a positive step towards these objectives.

There is also increasing focus from institutional investors on objectives outside of the E in ESG. Social impact, diversity, gender equality and social mobility are all gaining further attention. These areas are by their nature harder to quantify and while efforts have been made to derive consistency in metrics for diversity and gender related focus areas, it is likely that collecting this data, and therefore measuring the impact of investments, will remain a challenge for some time to come.

All of this shows how allocators need to stay up to date with what's coming next and how this influences their requirements for data and measurement needs.

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ISSB Sustainability Standards

- The IFRS Foundation announced the formation of the International Sustainability Standards Board (ISSB) at COP26 in Glasgow. The ISSB is developing standards that aim to "result in a high-quality, comprehensive global baseline of sustainability disclosures focused on the needs of investors and the financial markets."
- The ISSB has set out four key objectives:
  1. To develop standards for a global baseline of sustainability disclosures;
  2. To meet the information needs of investors;
  3. To enable companies to provide comprehensive sustainability information to global capital markets; and
  4. To facilitate interoperability with disclosures that are jurisdiction-specific and/or aimed at broader stakeholder groups.
- Two new standards have been introduced:
  1. IFRS S1: General Requirements for Disclosure of Sustainability-related Financial Information
  2. IFRS S2: Climate-related Disclosures
- The Financial Standards Board has announced that the TCFD has now been disbanded. Companies applying IFRS S1 and IFRS S2 will meet the TCFD recommendations as the recommendations are fully incorporated into the ISSB Standards.

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About Northern Trust

With more than 1,800 global asset owner clients, across corporations, not-for-profits, public funds, insurance companies, central banks and sovereign wealth funds, Northern Trust has an unwavering and longstanding commitment to support the increasingly sophisticated needs of complex asset owners and allocators.

Our goal within the Asset Owner segment at Northern Trust is to empower the missions of our clients, helping them to maximise investment returns so that they may then serve their constituents, their communities and the world we live in.

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About ORC

ORC provides cutting-edge advisory services to institutional allocators and investment managers globally. With assets under advisement of over USD1.5 trillion, we support our clients with comprehending and managing their end-to-end risk landscape, including ESG.

ORC's range of solutions encompasses ESG framework design, ESG due diligence, operational due diligence and custody and fund administrator selection and monitoring. We leverage sophisticated technology to provide efficient and cost-effective solutions to our clients whilst adhering to a robust framework that ensures the quality of our work.

Complexity is a language we speak fluently; we leverage our senior team's over 100 years of practical experience to proactively raise institutional investment standards.

To learn more

To find out more, please contact ORC at:

Enquiries@orclimited.com

www.orclimited.com

https://www.linkedin.com/company/77230917/