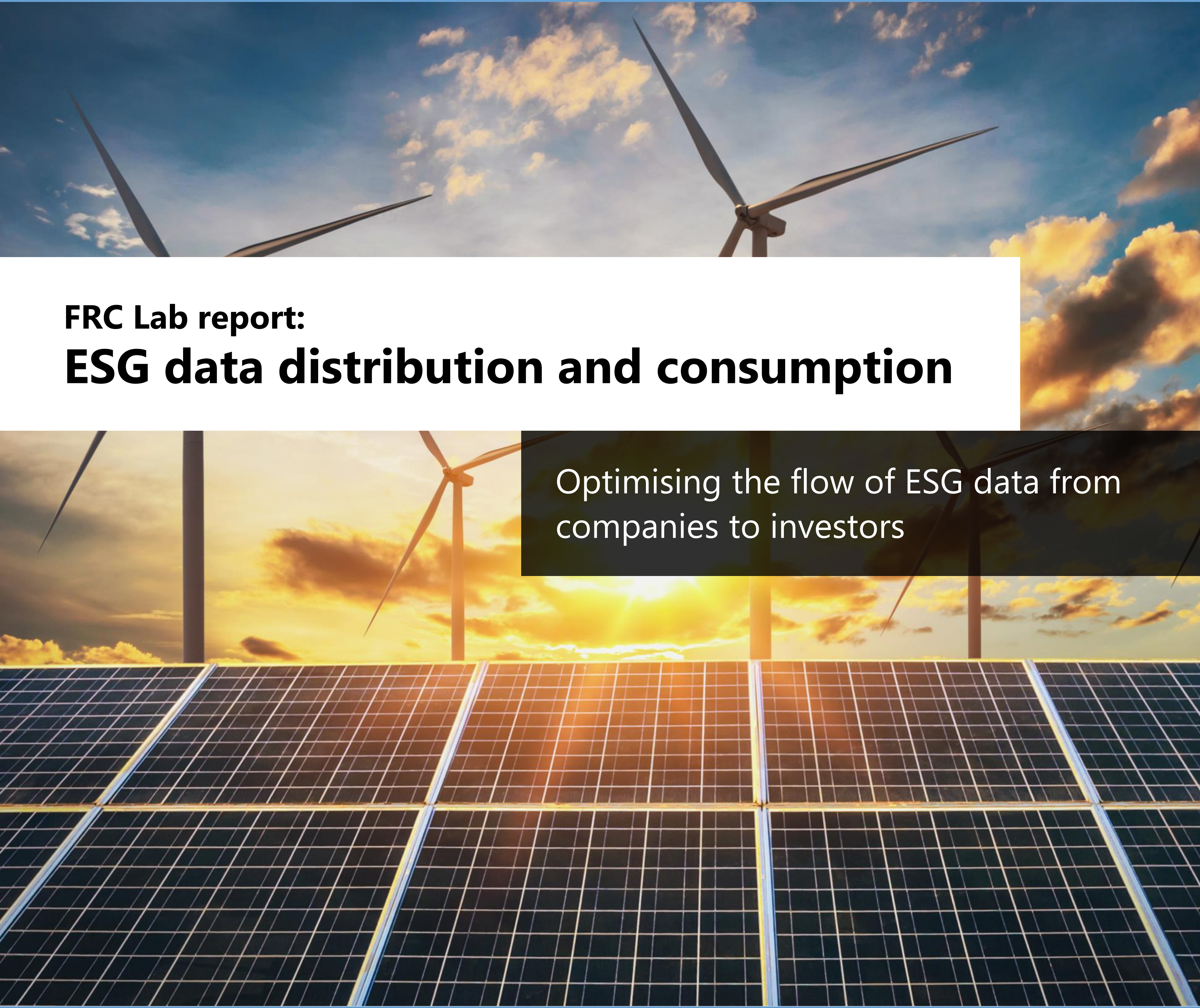
FRC
Financial Reporting Council



FRC Lab report:

ESG data distribution and consumption

Optimising the flow of ESG data from companies to investors

July 2023

Contents

This report has been prepared by the Financial Reporting Council Lab (the Lab).

If you have any feedback, or would like to get in touch with the Lab, please email us at:
FRCLab@frc.org.uk

Introduction and quick read

ESG is an increasingly important theme for investors. Global ESG-related assets under management (AUM) are forecast to reach US$33.9 trillion by 2026, or 21.5% of total global AUM. However, ESG is not just of relevance to investors with specific ESG-focused mandates. Mainstream investors are using ESG data to get a more complete assessment of the risks and opportunities for companies.

The FRC Lab's ESG Data production report formed the first phase of this project. In it, we looked at the production of ESG data from the company's perspective. The second phase of the project examines how investors access and collect ESG data (distribution) and how they use it (consumption). We then identify what companies can do to facilitate this.

This report is based on 90 interviews with participants from a wide range of organisations including investors, companies, data and rating providers, fintech solutions, consultants and academics, as well as a supplementary survey of 30 investors. We were primarily interested in how investors source ESG data and incorporate it into their investment processes, so we interviewed a diverse range of investors, of varying sizes, including active and passive managers as well as asset managers specialising in fixed income and private markets. We also spoke to asset owners and retail investors.

In our work on companies' ESG production, we identified three elements of companies' approach to ESG data. From our interviews, the same three elements emerged as relevant to why and how investors get and use ESG data:

- Motivation – What motivates investors to collect ESG data?
- Method – How do investors collect the data?
- Meaning – How do investors integrate ESG data into their investment processes?

What do we mean by ESG data?

ESG data stands for environmental, social and governance data. However, the focus of conversations with participants tended to be predominantly on environmental and social matters, with particular emphasis on climate issues due to both regulatory and investor pressure in the last few years.

ESG data is also sometimes referred to as non-financial information – although related issues can have a financial effect and this term may also include other topics. Some consider ESG to be synonymous with sustainability information and a company's impact, whereas others consider ESG to be focused on what affects the company, or both. For the purposes of this project, we sought to understand what investors consider to be ESG data.

Ultimately, this report aims to explore how companies can best serve their investors' data needs and communicate effectively their ESG priorities.

This report examines the current landscape of how investors collect and use ESG data as summarised below. Pages 7 and 8 set out recommended actions to optimise the flow of ESG data from companies to investors based on what we heard from participants.

Motivation

This element is about why investors are collecting ESG data. The key drivers are:

- **Portfolio construction and company analysis** – These can be further categorised as driven by:
  - *Reducing the universe of companies to a manageable size:* often by using ESG data for negative or positive screenings;
  - *Client mandates:* to comply with client requests, often to exclude certain types of companies from a portfolio; and
  - *Analysis:* to make the initial investment case and for ongoing monitoring of a portfolio.
- **Regulatory purposes** – These will be driven by regulatory requirements across different jurisdictions, including:
  - *Sustainable Finance Disclosure Regulations (SFDR)*: to comply with regulations which govern asset management firms selling products in the EU; and
  - *Task Force on Climate Related Disclosures (TCFD):* for the asset management firms' own TCFD reporting.
- **Stewardship** – Investors use ESG data for different types of engagement to meet their stewardship duties:
  - *Risks:* To engage with companies where data indicates ESG-related risks with a view to improve performance; and
  - *Progress:* To monitor companies' progress on ESG priorities and assess whether engagement is needed.
- **Client reporting** – Asset managers need to satisfy client reporting demands as their interest in ESG continues to grow. Clients include both:
  - *Asset owners:* to monitor that their external managers are investing according to their mandate; and
  - *Retail investors:* to understand the ESG characteristics of the funds in which they invest.

Challenges for investors include:

- Data regulations introduced for investors ahead of companies; and
- Concerns around fund labelling and risks of accusations of greenwashing.

Method

This element sets out how data is collected and prepared for use by investors by identifying:

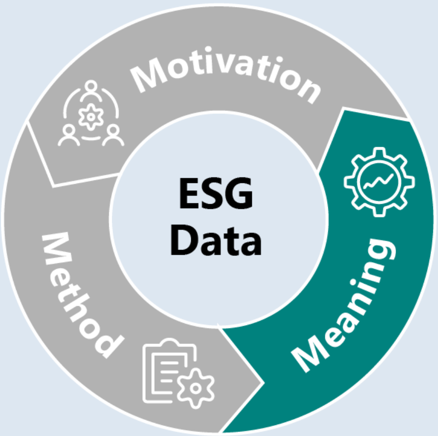
- **Sources** – There are two main methods by which investors collect ESG data:
  - *Direct:* data collected from materials published by companies and from interactions between investors and companies; and
  - *Indirect:* data collected via third party data providers – typically investors pay for the service. This data is primarily derived from company reporting and then subject to a level of standardisation, or from other sources such as the media.
- **Processing** – Most investors have ESG teams, whose role is to process the data for use by the investment and stewardship teams. Their role typically includes:
  - *Selection:* selection of the most appropriate data providers;
  - *Collection:* aggregation of ESG data in a centralised location/library;
  - *Ranking:* developing proprietary ESG scores; and
  - *Reports:* writing thematic or company-specific reports on ESG issues.
- **Materiality** – Many investor ESG teams use a formal materiality assessment to help them identify and focus on the ESG data they expect to be most useful and relevant for a company.

Challenges associated with this stage of data consumption include:

- Timeliness of data, as sustainability reports are not always published in conjunction with the annual report, and due to the cyclical nature of updates by data providers. This means that the information investors use for decision-making may be out-of-date;
- Lack of clarity on the methodology of the ratings and data providers; and
- Cost limiting the ability to use multiple data providers.

Almost all investors rely heavily on third party providers for their ESG data as it is a more time-efficient process when covering a portfolio of multiple companies rather than sourcing the data individually. However, they also use companies' narrative reporting to understand companies' ESG priorities and to obtain a qualitative context for the data and metrics. Many investors state that they primarily use the underlying data and pay limited attention to ratings from ESG ratings providers, but ratings may be monitored for changes or outliers.

Meaning



This element looks at how investors integrate ESG data into their investment processes. How data is used will to an extent depend on the size and type of the investor. However, some commonalities in approaches to the use of ESG data include:

- **Qualitative, not quantitative** – Although some investors attempt to combine financial and ESG data, or use the data to adjust discount rates when analysing companies, most investors use it as a qualitative overlay when assessing companies' prospects;
- **Specific issues** – Some investors focus on a specific ESG issue and use it to engage with companies; and
- **Monitoring** – Many investors use ESG data to monitor companies' performance on ESG issues over time.

It is likely that, as more and better quality ESG data becomes available, investors will increasingly build it into their company analysis models.

There are a number of challenges which limit the degree to which ESG data is integrated within financial analysis:

- Quality of data due to the manual nature of data providers' processing of company data, as well as the lack of clarity on use of estimates;
- Volume of data risks obscuring relevant ESG issues and metrics if the annual report does not focus on what is material;
- Jurisdictional differences in data availability and quality, particularly in emerging markets; and
- Data gaps, particularly in social, biodiversity and water data.

Optimising the flow of ESG data from companies to investors:
Actions to facilitate how investors and data providers consume ESG data

1. **Understand who your audiences are and target accordingly**
    - Keep the annual report as the main vehicle for reporting aimed at investors and consider whether a standalone sustainability report is more appropriate for other stakeholders.
    - Proactively engage with investors to understand which ESG issues are important to them and how they are using your reports and communications. Web analytics may be useful, and it may also be helpful to understand your largest investors' ESG priorities and methodologies as set out on their websites.
2. **Focus on what is relevant to your company in the annual report and provide further detail in datasheets**
    - Remember that investors are getting their ESG data primarily from third party providers and are likely to use your annual report to further their understanding of your ESG risks and opportunities.
    - Focus on ESG issues specific to the company, explain your priorities and how these issues impact performance, business model and strategy within the annual report.
    - Do not obscure relevant information. Remember that investors are time-poor and considering multiple companies.
    - Use datasheets as one easy-to-find repository of a company's ESG metrics and other information to facilitate data collection by data providers and investors' data teams.
3. **Ensure a coherent and interconnected narrative backs up the data**
    - Ensure that the messaging of your narrative reporting correlates with the performance reflected by the data and financial reporting to avoid greenwashing and maintain credibility.
4. **Be clear on scope of the data**
    - Clarify where issues or metrics do not apply to the whole group but to a specific geography or division so that investors can understand how they relate to overall performance.
5. **Provide clarity and consistency of location of information year-on-year**
    - Signpost clearly where data on an issue or reporting against a particular framework can be found within your reporting or website, and maintain the same location year-on-year as much as possible to facilitate the process for analysts, data providers and automated data scraping tools.
6. **Align timing of ESG reporting as much as possible to that of the annual report**
    - Aim to provide ESG reporting for the same period and at the same time as the annual report.

Optimising the flow of ESG data from companies to investors:
Actions to facilitate how investors and data providers consume ESG data (continued)

7. **Simplify content and keep it meaningful to facilitate data collection, including digital scraping**
   - Keep content clear, with minimal use of images and annotate pie-charts/graphs.
   - Make it clear where data was assured and at what level.
8. **Aim for comparability of data presentation**
   - Provide comparative historical data, ideally up to 5 years, to assist in trend analysis.
   - Use internationally recognised standards and industry frameworks as much as possible in relation to metrics for better comparability with peers.
9. **Prepare for further digitisation**
   - Apply lessons learnt from using financial reporting digital taxonomies to ESG reporting.

Boards also have a role to play in understanding their major shareholders and their requirements for ESG data and addressing how their companies can better meet these disclosure needs. Boards can ask:

- How do we engage with investors to understand what ESG data is important to them and why?
- What frameworks are investors using to assess us and our peers?
- Are we engaging with the data providers our major investors use?
- Have we reviewed the ESG ratings awarded to the company by the ratings providers and engaged where necessary? Would it be helpful to include them and add relevant commentary on our website?
- Does our annual report help investors to understand which ESG issues are important to our company and how they relate to our performance, risks, business model and strategy?
- Does our narrative reporting give a sense of our progress towards our ESG goals and correlate with the performance reflected in our ESG data reporting and the financial statements?
- Is it possible to align the publication of our sustainability information and to cover the same time period as our annual report?
- Can we put ESG data into a datasheet, which investors can easily access in one place and use to identify trends?
- Have we considered which ESG metrics should and can be subject to external assurance?
- Is it possible for us to map our ESG data to investor reporting requirements, such as SFDR?

1. Motivation

All the investors we spoke to were using ESG data in their investment process to some extent. What motivates them to collect ESG data? This varies depending on the type of investor, but data collection was typically used for the following:

- Portfolio construction and company analysis;
- Regulatory purposes;
- Stewardship; and
- Client reporting.

Portfolio construction and company analysis

Many active managers use ESG data as a screening tool. There are a number of reasons why they might choose to do this:

- **To reduce the universe of companies to a more manageable size:** Most active managers will use some basic screenings to limit the number of companies they have to research. For example, they may use negative screening to exclude companies which they believe to be at risk of being negatively impacted by ESG-related issues, or positive screening to select the companies which are perceived to be leaders in sustainability or which can benefit from ESG-related opportunities. The granularity of ESG data required for this screening will vary; some active managers will be looking at metrics such as percentage of revenues dependent on carbon, others will be excluding (or including) specific industries.
- **For client mandates:** Some clients may request that their asset manager does not invest in particular types of companies, such as those involved in fossil fuels, weapons or tobacco.

Once the active manager has done the initial screening, they begin the process of in-depth analysis on the companies they are considering to buy. They use financial data to measure a company's performance over time and to forecast the likely trend of earnings. Increasingly, they are using ESG data to enhance their understanding of the risks and opportunities for the company and to help decide whether it is under or overvalued.

Quantitative fund managers may use ESG data to devise rules which they will use to automatically select and trade companies for a particular strategy.

The process does not end once the active manager has made the decision to buy a company. The weighting of that company in the portfolio will depend on the level of conviction about the company's prospects. This demands ongoing monitoring of financial and ESG data. Active managers also monitor their portfolio companies for any controversies, which might have a negative impact on the initial investment thesis.

Regulatory purposes

Regulation and related reporting requirements for investors have been a significant driver for data needs. Global securities regulators have implemented reporting requirements designed to prevent asset management firms from making unsubstantiated claims of sustainability for their products. Several investors told us that the enhanced regulatory reporting requirements, particularly the EU's Sustainable Finance Disclosure Regulations (SFDR), had caused them to increase the amount of ESG data they collect about the companies in which they invest and to systematise the collection process. They also described the process of producing their first SFDR reports as challenging since the rule was introduced before companies were required to report the underlying metrics. This led investors to request more data directly via questionnaires to companies. As a pre-emptive measure, some companies are now mapping their ESG data to both SFDR and Principal Adverse Impacts (PAIs) within their ESG datasheets to make the process easier for investors. As part of these requirements, investors need more data on areas such as biodiversity, water, pollutants and human rights, which present new challenges.

Asset management firms and asset owners also use ESG data for their own Task Force on Climate-related Financial Disclosures (TCFD) reports as required by the Financial Conduct Authority (FCA) and the Department for Work & Pensions.

Stewardship

Stewardship requirements are growing in a number of jurisdictions. In the UK, the Stewardship Code defines stewardship as 'the responsible allocation, management and oversight of capital to create long-term value for clients and beneficiaries leading to sustainable benefits for the economy, the environment and society'.

Environmental factors can have a significant impact upon companies' ability to create long-term value and have therefore become material issues for investors to consider when exercising stewardship.

Investors will choose to engage (sometimes in collaboration with other investors) with companies for which the data indicates ESG-related risks, with a view to improving the companies' performance and, hopefully, raising their valuation and prospects for future returns. If that engagement proves unsuccessful, they may choose from a variety of escalation mechanisms such as voting against management at the company's annual general meeting, or, as a last resort, divestment.

Investors expect to learn about companies' ESG priorities and goals from their annual report or sustainability report. They use ESG data to monitor progress towards those goals and engage with management if they feel that progress has been too slow.

Client reporting

Another motivator for ESG data collection is to satisfy client reporting demands. Investors told us that their clients are interested in learning more about the ESG characteristics of the funds in which they invest. To date the information available to clients has mostly taken the form of fund-level disclosures of metrics such as carbon intensity, alignment to a net zero target or a weighted average ESG score for a portfolio. Investors said that they receive some questions from clients about their rationale for owning companies with lower ESG ratings. The trend towards categorising funds by their sustainability intent is likely to increase clients' demands for additional ESG information on their investments.

2. Method

Sources of ESG data

There are 2 main methods by which investors collect ESG data:

- **Direct** – data collected from materials published by companies and from interactions between investors and companies; and
- **Indirect** – data collected via third party data providers – typically investors pay for the service. This data is derived from company reporting and then subject to a level of standardisation. The providers often also give an ESG score or qualitative report on the company. This is by far the most used source of ESG data for investors. Data on a company may also be collected via other sources, including the media, not-for-profit initiatives and new technological solutions.

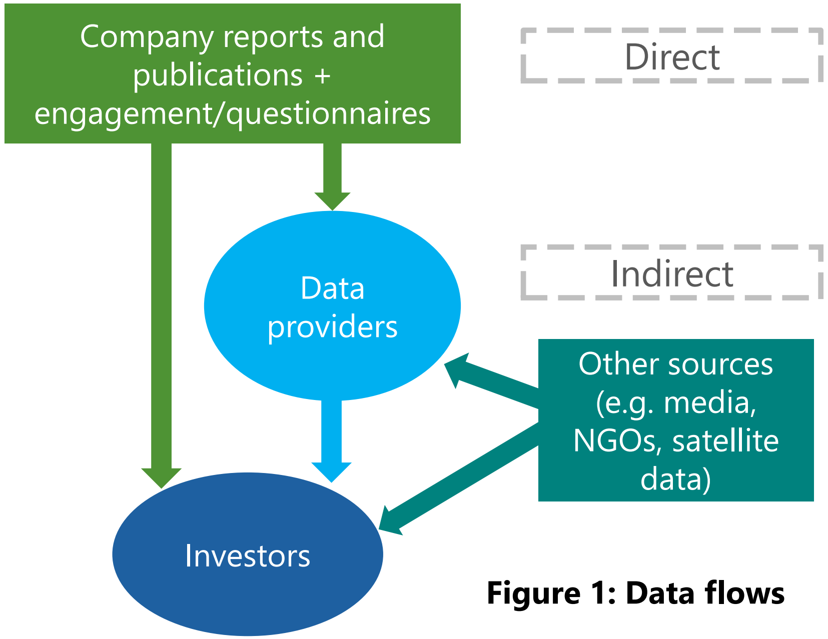


Figure 1: Data flows

Direct data collection

Investors explained that, although they obtain ESG information from companies' annual reports, sustainability reports and datasheets, these are typically not the primary source of ESG data. Instead, these provide the qualitative context around the data which is being sourced from third parties. Company reports are necessary for understanding the full picture around a company's ESG priorities and how ESG issues affect financial performance and future prospects. However, metrics and data may be more efficiently obtained via third party providers. Occasionally investors use directly obtained data to check the third party data.

Several investors told us that datasheets are useful when they show historic information, which they can use to monitor progress towards companies' sustainability targets and to identify performance trends.

Although some investors send questionnaires to companies asking for data on a regular basis, several told us that they are wary of placing an additional reporting burden on companies. However, new regulatory requirements have prompted some investors to send questionnaires to companies to fill in any missing data.

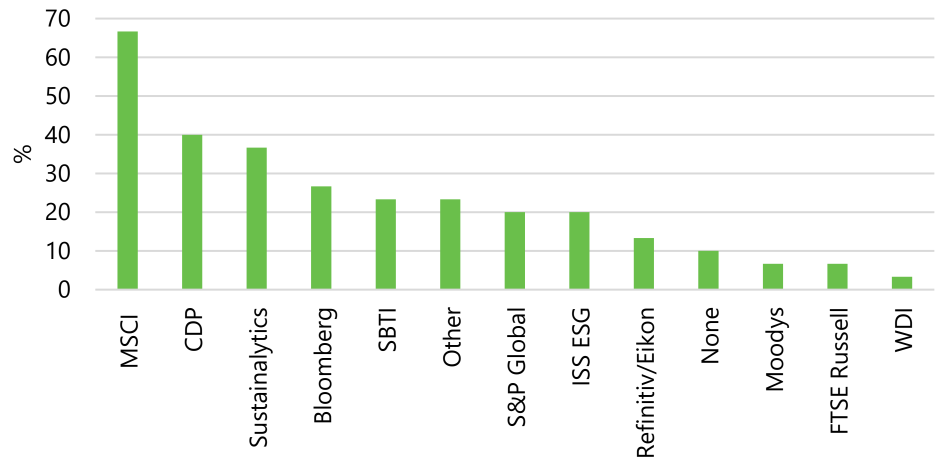
Indirect data collection

As highlighted in Phase 1 of the project, the process of producing ESG data is much less mature than that for financial data. This means that the quality of data reported by companies varies significantly. This is one reason why investors typically expressed a preference for data aggregators over companies' reports in the first instance. They rely on the providers to implement some basic checking and standardisation of the data and to supplement missing data with estimates. In many cases they extract the data directly from the provider via application programming interfaces (APIs). In addition, data providers are facilitating the process for investors with portfolios of tens or hundreds of companies – accessing the data individually for each company would be a very time consuming exercise.

As part of our survey of investors, we asked which third party data providers they used for ESG data. They were allowed to pick multiple answers. The results, shown in the adjacent graph, correspond with the findings of a June 2023 report published jointly by Morrow Sodali, Durham University Business School and the FRC which examined the influence of ESG ratings agencies and proxy advisors.

Investors told us that, ideally, they would like to source their ESG data from a range of data providers. Most do use more than one and find it helpful to triangulate data points between them. They also recognise that different providers have different strengths. However, cost is a major limiting factor, which is why many typically rely on one main provider, chosen on the basis of coverage, supplemented by some other specialist third party providers.

Figure 2: Survey question: which ESG data providers do you use?



Cost and coverage are not the only factors in choosing a data provider. Specialisms and strengths in particular topics or methodologies may play a role and services are being developed (both by private consultants and investor-led initiatives) to help investors make that choice. For example, the Institutional Investors Group on Climate Change (IIGCC) has published a Net Zero Data Catalogue which reviewed net zero alignment data offered by 16 data vendors, and also published a guide with 6 asks of data vendors for improving net zero data provision.

The role of data and ratings providers

Who?

There are many players in the field but these can generally be grouped as:

- **ESG ratings providers**
  ESG ratings providers are the most frequently used source of ESG data, partly because of the breadth and depth of coverage they offer. Many investors emphasised that, although they previously focused on the ESG ratings assigned by the ratings providers, they now primarily use the underlying data and pay less attention to ratings. This is corroborated by the Rate the Raters survey. However, it is clear that most investors are aware of ratings, monitor changes in ratings for individual companies and, in some cases, use them as an input to regular portfolio reviews.

- **General data providers**
  Investors supplement data from the ESG ratings agencies with information from general data providers. These data providers offer ESG data as an additional resource for users of financial data. Whereas the ESG ratings providers often provide ESG research reports on individual companies, the general data providers focus on the ESG data itself.

- **Specialist ESG data providers**
  Some investors use data from specialist ESG data providers. There are increasing numbers of entrants to this field. Some offer the ability to map data to different reporting frameworks. Others focus on specific topics such as controversies, workforce or supply chain issues.

How?

While data providers vary in size and resources, there are similarities in approaches to gathering and processing the data:

- **Manual extraction from primary sources of company data:** providers employ analysts to comb through companies' public filings, reports (including annual reports, sustainability and corporate social responsibility reports) and other communications such as press releases and policies on websites. This extraction and analysis may involve a degree of judgment. Some providers have dedicated sector analysts.

- **Use of other non-company sources:** providers use scraping tools or subscriptions to specialist media for company references on ESG issues, particularly controversies. They also use data from NGOs, other specialist providers and industry publications.

- **Input from companies:** some providers allow companies to provide feedback on the data collected or to input missing data points and further information onto their platform – backed up by published information.

- **Estimates and modelling of data:** estimates are used to fill in gaps where company disclosure is limited or to create new data sets such as "green revenues" using company data on energy use or using industry averages. Estimates are particularly prevalent for calculating Scope 2 and 3 emissions.

Ratings and underlying data are typically provided to investors via API, and other third party distribution platforms.

The role of data and ratings providers (continued)

Companies' experience with data providers

Companies have to respond to various data providers to address their investors' data needs. While providers offer opportunities for company feedback, companies noted that it was sometimes difficult to engage with data and rating providers to discuss any issues or errors with the data points published by the providers. At least one provider offers a solicited service for a fee where they advise companies on how to improve their reporting and, as a result, their rating. However, it was not clear to what extent this impacts the rating. Companies commented how some providers' feedback process was only every two to three years in spite of a yearly update to the rating. In addition, some providers only provide the rating to paid subscribers so companies do not always have visibility over that rating and underlying data. Another frustration was that companies were occasionally classified in the wrong sector or industry, or not all factors considered for that industry were applicable to the company but they were penalised as a result. A recent IR Society survey on companies' experience with data and rating providers corroborates these findings.

"Assessments by rating providers feel like something done *to* you rather than with you – we don't feel we can control it" Company

Companies found it helpful when:

- they are assigned an analyst or contact to facilitate engagement and providing feedback, as well as enable them to understand the assigned score;
- the provider is clear on the methodology, the source of data used and when the rating was last updated.

Regulating ESG data and ratings providers

In the past few years, as the focus on ESG grew and so did the use of ESG ratings providers, the debate on whether these organisations should be regulated has persisted. In 2021, the International Organization of Securities Commissions (IOSCO) published its report on ESG Ratings and Data Products Providers in which it set out a proposal for regulators to focus greater attention on these providers, as well as recommendations for the providers themselves. The recommendations concerned:

- enhanced transparency on methodologies and data sources;
- management of conflicts of interest; and
- governance and controls.

As a result, in 2022 the UK Financial Conduct Authority (FCA) announced that it saw a clear rationale for regulatory oversight of certain ESG data and ratings providers informed by IOSCO's recommendations on ESG data and ratings and it would engage with HM Treasury on possibly bringing ESG data and ratings providers within their regulatory perimeter. In March 2023, HM Treasury issued a consultation on the future regulatory regime for ESG ratings providers. The consultation closed in June 2023 and responses will inform the government's next steps.

In the meantime, ahead of regulation, the FCA appointed the International Capital Market Association (ICMA) and the International Regulatory Strategy Group (IRSG) to convene an industry group to develop a voluntary Code of Conduct. The group is composed of stakeholders including investors, ESG data and ratings providers, and rated entities. The Code is now out for consultation and takes into account the IOSCO recommendations as well as developments in jurisdictions such as Japan and the EU.

Other sources of indirect data collection

- **Non-profit initiatives and thematic platforms**
  Many investors and companies have signed up to initiatives such as CDP, which send detailed questionnaires to companies on areas such as climate change, forests and water security and then assign a score based on their response. There are also several thematic platforms, focusing on specific ESG issues, which investors use for a more detailed perspective on areas of particular interest to their strategies. The Workforce Disclosure Initiative (WDI) produces data on workforce issues. The World Benchmarking Alliance (WBA) benchmarks companies to the UN's Sustainable Development Goals. Other benchmarks and tools may be more industry specific, such as the FAIRR Initiative (FAIRR), a collaborative investor network, which focuses on the global food sector and has produced a Protein Producer Index.

- **Open-source data**
  Some investors use open-source data, but this is a supplement to, rather than a replacement for, other sources of ESG data. For example, the UK Power Networks Open Data Portal has one of the UK's biggest sets of information about the electricity network. Whilst the information is aimed at their suppliers, it is also a useful source of information for investors. There are other open data platforms on which communities of contributors collect and analyse data on companies' commitments and actions.

- **Credit ratings agencies**
  Credit ratings agencies use ESG information when assigning their credit scores and this information is used by credit investors to assess the impact of ESG factors on credit default risk. Unlike with ESG ratings, which are paid for by investors, these ratings are paid for by companies.

- **Technology solutions**
  Innovation is bringing about rapid developments in ESG data collection. Satellite imagery and sensing technology offer new ways to collect ESG data. Scraping tools trawl websites for ESG information and news sites for information on controversies. Artificial intelligence techniques such as natural language processing allow providers to amalgamate vast amounts of unstructured qualitative information from the internet and turn it into a quantitative score. To date, only a few investors are making use of these new resources, but many are interested in building them into their ESG data processes.

Private markets

Privately-owned companies are less likely to be covered by third party data providers and few have the resources to produce ESG data voluntarily. However, many private equity managers are requesting ESG information from their portfolio companies. Some consultants and industry associations have devised templates to help companies with the process of data collection, which require companies to report on a limited number of material datapoints. Most private equity managers rely on direct engagement with portfolio companies to access the information they require.

Processing of ESG data

The role of ESG teams

Most institutional investors have internal ESG teams, who provide specialist ESG knowledge to the rest of the firm. They select the ESG data providers, collect the data, process it and disseminate it to the investment teams. The amount of processing varies from one firm to another, but some ESG teams use the data to construct their own proprietary ESG scores, often breaking them down into separate scores for environmental, social and governance factors. Investment teams are free to use the resources provided by the ESG teams as they choose, but in some cases, they are not allowed to invest in companies which score below a certain threshold. Generally, however, as one investor put it, the central ESG team is "a support function, not a control function".

The ESG teams often produce thematic reports, write research notes on individual companies, flag companies for engagement and occasionally accompany the stewardship or investment teams to company meetings.

Materiality

There is a huge amount of ESG data produced, not all of which is relevant for every company. Many investors use a formal materiality assessment to help them identify and focus on the most useful ESG data.

Most use the Sustainability Accounting Standards Board's (SASB's) materiality map, which shows how sustainability issues affect 77 different industries. For some investors, the SASB materiality map does not go far enough, so they break industry groups down further or consider if there are material issues not included in the map. Others ask their analysts to identify the relevant ESG risks and opportunities for each individual company they analyse. This work helps them to determine the ESG data which is most relevant for each company and to identify what to engage on.

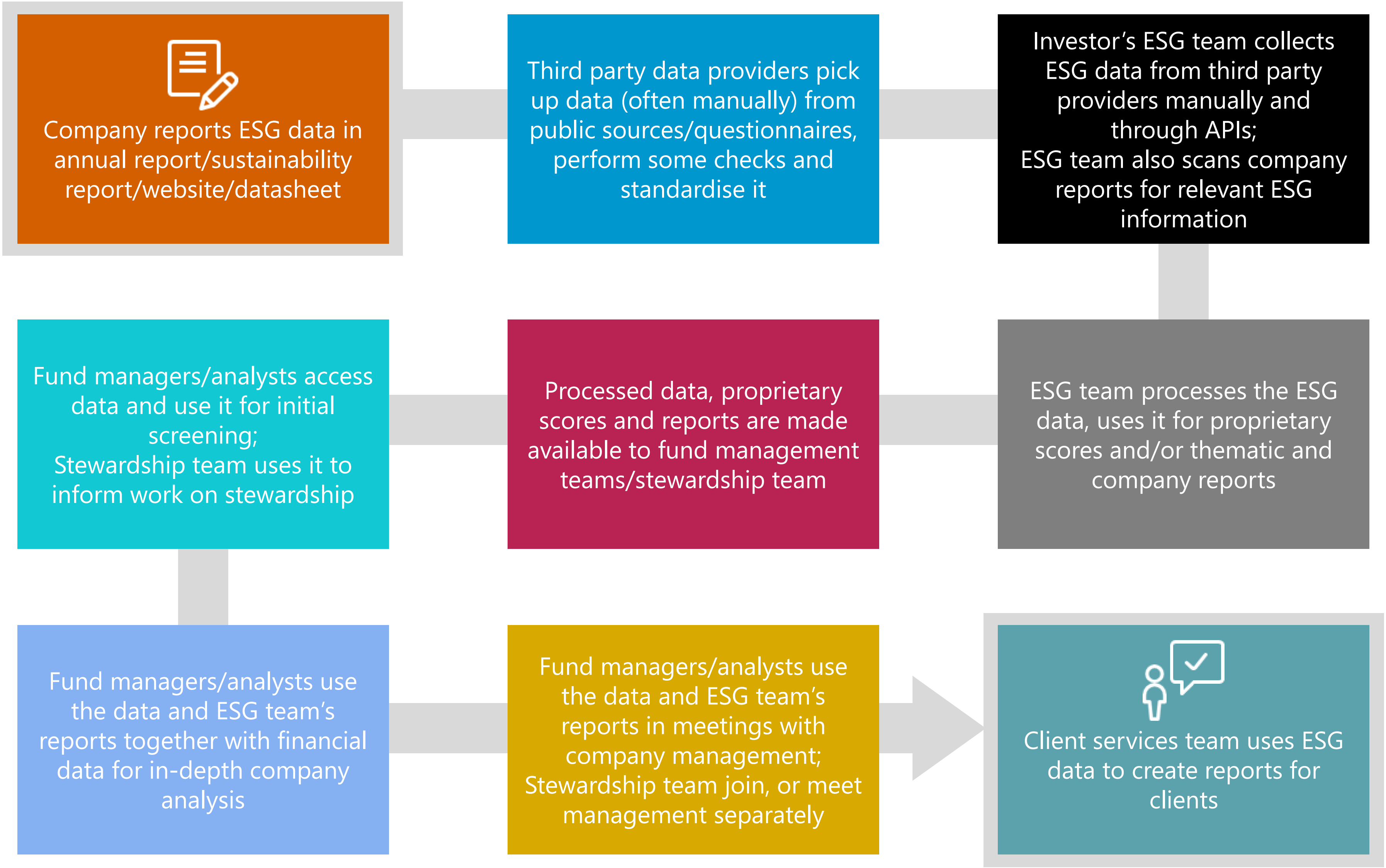
Investors are interested in understanding which ESG issues companies class as material through inclusion in the annual report and also look at which issues companies choose to exclude from their reporting if the investors consider such issues as relevant for the sector.

Assurance

Investors expressed a range of views on the desirability of external assurance for ESG data. While viewed positively if undertaken, for most, assurance did not appear to be a high priority as the effort should be focused on producing the data. However, they felt that it would become more important over time. Some expressed scepticism about the number of suitably qualified individuals to do the assurance. Data providers, too, placed little to no emphasis on assurance of ESG data.

However, where companies produce data which is assured, investors do appear to place a higher reliance upon it.

Figure 3: ESG data – from input to output at an active equity investor



3. Meaning

How investors use the data

Collecting the data is only half the battle. Making meaningful use of it for investment purposes is the challenge. Although investors believe that ESG data covers risks and opportunities which are essential to the understanding of a company's prospects, they acknowledge that the data is less mature than financial data. In our interviews with investors we attempted to understand how they incorporate the data into their investment process.

Investors use financial data as a key input when they decide whether to buy, sell or hold a stock. ESG considerations can be an input among others in making those decisions but are rarely a sole deciding factor. Investors face several challenges to building ESG data into mainstream financial analysis.

Financial data	Current ESG data
Accessed from single source	Accessed from multiple sources
Recent	Reported with significant lag
Standardised	Some standardisation
Comparable	Not easily comparable
Company data	Often contains estimates

Investors are using the data in a variety of ways:

- Although many investors do an initial screening which uses ESG data as a filter to exclude (or include) certain companies, they also use material ESG data as a qualitative overlay in the investment decision-making process. There is limited use of ESG data when building financial models and they do not incorporate ESG scores or ratings into company analysis. However, just because the data is not used in the same way as financial data does not mean that investors pay less attention to it. Their overall ESG assessment of a company may have an impact on the valuation premium (or discount) they give it.
- Some investors are trying to combine ESG and financial data to produce ratios such as return on human capital investment. Others incorporate ESG factors by adjusting discount rates to take account of ESG-related risks and opportunities for companies. However, there are challenges in combining financial data, which is reported quarterly, or semi-annually, with ESG data, which is produced once a year.

"Data just sits there. Information is what you glean from it"
Investor

The International Sustainability Standards Board (ISSB)
In June 2023, the ISSB published its first two IFRS Sustainability Disclosure Standards as part of its project to provide a consistent international set of standards for sustainability reporting. Investors are broadly supportive of this initiative, believing that it will narrow the differences in terms of methodologies between the data providers. However, they believe that it will take some time for the ISSB to cover the full suite of sustainability data.

- Some investors focus on a specific ESG issue, look for data that is relevant to that issue and use it to engage with companies, to push them to meet targets.
- Many investors use ESG data to monitor companies' performance on ESG issues over time. For this reason, investors would like to see data which covers at least 5 years.

As more historic ESG data becomes available and it becomes easier to observe trends, it is likely that the use of ESG information in forecasting (capital expenditure burdens to meet net zero commitments, terminal values, discount rates, etc.) will become more prevalent.

> "A large part of our ESG process is qualitative, because there is not enough data. Some of the lack of data can be solved by engaging directly with issuers, but a qualitative overlay is still important. It's impossible to get the same statistics for each entity so the judgement has to be based on other factors"
> **Investor**

Retail investors
We interviewed retail investors who are members of active retail investors groups and invest individually or through funds.

Motivation

Many retail investors take a keen interest in ESG. Indeed, it seems probable that this interest will continue to grow, given that younger investors appear to be even more likely to incorporate ESG factors into investing than their parents. However, some retail investors struggle to reconcile their desire to invest sustainably with the need to maximise investment returns.

Method

ESG data providers' services are too costly for retail investors. Most do not have the time or resources to read through annual reports and sustainability reports, but will occasionally view ESG information on a company's website. Many use media reports as a primary source of information on ESG.

Meaning

Some retail investors, who buy individual shares, attempt to select companies which have a positive environmental or social impact. Others avoid companies which are either at risk from climate change, are thought to have weak environmental or social practices or are involved in controversies. Investors who buy funds use the ESG information provided by the asset manager to decide if the fund they are buying meets their ESG aims and matches their values.

Retail investors are also increasingly active in voting their shares, thanks to initiatives from some of the investment platforms which have made this possible. Many are using this opportunity to vote on ESG-related issues.

Each of the 27 investors interviewed for this project integrate ESG data in their processes in a slightly different way. However, the following three approaches were often taken:

Systematic approach

The relationship between the ESG team and the investment team is critical to the smooth integration of ESG factors into the investment process.

Some of the active managers we interviewed had developed a systematic approach to producing internal ESG scores. ESG teams use a combination of company and third party ESG information to develop these. The scoring system typically uses a series of questions that look at environmental, social and governance factors separately. Each factor is then weighted according to its perceived level of materiality for that sector. For example, for sectors which are emissions-intensive, the environment score has a higher weight. For some of the service sectors, such as recruitment, social and governance factors are the focus. The score can then be upgraded or downgraded depending on how well the company is performing on each of the factors. If the company is in an emissions-intensive sector, a strategy to get to Net Zero, with transition plans and (preferably) science-based targets would lead to an upgrade of the score.

ESG scores are an initial input for when the investment team screen the universe of companies for new ideas and company selection. For ongoing monitoring of companies, the internal ESG score is usually updated once a year or more frequently if the ESG team becomes aware of any controversies.

In-house approach

A few investors have embarked upon the process of building their own data resources and internal data platform. This is an expensive and time-consuming business. Some active managers are working with academia, bringing in expertise from data scientists, climatologists and others in order to build a better model of the trajectory of emissions and the likelihood of a company meeting its climate goals. The aim is to give investment teams information about the likelihood of companies meeting their net zero targets or to build portfolios tilted towards a particular transition pathway. However, even these processes often take third party data as a starting point.

Flexible approach

In other asset management firms, the ESG team is established as an area of deep specialisation and expertise, but rather than developing internal scoring systems, these teams focus on the production of reports on individual companies and working papers on ESG topics, which are uploaded to a central research library. They use data from third party data providers, but they are not necessarily looking for specific ESG data points. Instead, they use the information as a qualitative consideration that feeds into the long-term investment case for a company.

The investment teams have complete freedom to use these resources as they see fit. Investment teams may choose to discuss ideas with the ESG team, or even to have one of the ESG analysts embedded with them. Generally, the ESG team's reports are used by the investment team along with other inputs to help them build a fundamental case for investing in (or divesting from) a company.

Challenges for investors

- **Quality of data** – Although ratings agencies' coverage of companies and metrics is extensive, by the time the data is published, it can be months out of date. This is partly because some companies produce their sustainability report after their annual report, but also due to the cyclical nature of updates by the providers. Moreover, huge quantities of data and mostly manual processes mean that ESG ratings providers' data is not always entirely accurate. A number of participants commented that the ratings providers' methodologies were a 'black box'.
- **Jurisdictional differences** – It is easier to access ESG data in jurisdictions which have been focusing on sustainability for longer. In some emerging markets, ESG data disclosure, although improving, is less mature than in developed markets. Even in mature markets, different frameworks and reporting requirements impair comparability.
- **Data gaps** – Data on greenhouse gas emissions and other climate metrics is readily available. However data on social factors is much more difficult to source, partly due to regulations around data protection and partly because it is easier to construct comparable metrics on climate issues. Investors are increasingly focusing on areas such as biodiversity, but many find it difficult to source (and interpret) useful information on this topic, as well as on areas such as water and waste. And, even in climate metrics, there is often a lack of information relating to physical climate risk.
- **Use of estimates** – In their efforts to build complete sets of ESG data, data providers often use estimates. It is not always clear to investors where providers have used estimates, how they have been calculated and, in some cases (Scope 3 data in particular), the accuracy of those estimates is questionable.

Tips for investors

The following recommended actions for investors could help improve the quality of ESG data they receive from companies:

- **Use your influence with data providers.** Signatories to the UK Stewardship Code 2020 are expected to monitor and hold to account service providers. It seems that data providers are often more responsive to investors, who are paying for ESG data, than to companies, which are not. Ask for clarification of data points which seem out of line. Push the data providers to correct any errors you detect.
- **Engage with companies.** According to a recent survey by the IR Society, many companies do not know which ESG issues are considered financially material by their investors. Also, many of the companies we interviewed remarked that investors spend very little time on ESG issues in meetings with management. Discuss your ESG priorities with companies. Encourage them to use their narrative reporting to talk about the ESG issues which are material to them and to reflect those issues in their financial statements as appropriate under applicable accounting standards. Use meetings with management to discuss progress on those ESG issues.
- **Consider the burden on companies** when sending questionnaires to them. Rather than asking companies to respond to surveys from individual asset management firms, it may be more helpful to coordinate your approach through an initiative or an investor group.
- **Take a proportionate and more engagement-based approach with small companies.** Data providers will often penalise companies for incomplete data. Remember that large companies have teams of people whose job it is to produce ESG data. In smaller companies, this is often something done on a part-time basis by one of the management team.

What does this mean for companies?

As highlighted in the Lab's ESG Data production report, addressing investor and data providers requests is a major motivator for companies to report ESG data, both in publicly available reports as well as direct submissions. Challenges highlighted in that report included multiple similar but nuanced requests, and data points which are not relevant to their company. However, they recognise that data and ratings providers are a critical intermediary for investors to access their ESG data.

Some companies undertake an exercise to understand which data providers to prioritise for responding to questionnaires and engaging with, based on their knowledge of their investment base and which providers their investors are using. Some also recognise that on occasion the level of engagement may not necessarily be very time consuming and it may be worth the effort to retain a rating or inclusion in an index. One company explained that their assessment first considers the Rate the Raters survey and surveys conducted by investment banks which typically highlight the same providers as the major players. Besides anecdotal evidence on which providers their existing investors are using, they identified the top passive ESG funds on their share register, as well as of their peers, and the ESG benchmarks these funds use. They then ranked the benchmarks by dollar value based on the shareholding. This allowed the company to focus and prioritise those data providers associated with the highest ranked benchmarks.

Some companies provide their various ratings on their website. They may include information on:

- when the rating was last updated;
- how the rating compares to the maximum possible and to peers or industry average;
- comparative periods for the rating to allow for trend analysis; and
- the company's own assessment of the factors considered by the rating provider and what feedback they gave to the provider.

Whether ESG data is consumed directly from a company's reports and communications or via a third party provider, the data should address both the intermediate and the ultimate users' needs to ensure that it is being accessed accurately and completely. This should enable a better representation of a company's performance and, as a result, more effective decision-making by investors.

What should companies do to facilitate how both investors and data providers consume data?

- **Understand who your audiences are and target accordingly** – Where possible, once you identify who your users are, engage with them, or assess through web analytics, on how they are using your reports and communications. The annual report is the main vehicle for reporting aimed at investors. To be truly useful, one report cannot be all things to all people. While integrated reports are preferred by some investors, if taking that approach remember that the target audience is still providers of financial capital. Be careful that the report does not become unwieldy and difficult to access and search through. If you want to target other stakeholders, consider whether a standalone sustainability report is more appropriate, while still addressing financially material ESG issues in the annual report.

- **Focus on what is relevant to your company** – While requests may sometimes relate to data points which are not considered material by company management, the annual report should focus on ESG issues specific to the company and how these impact performance, business model and strategy. It is important not to obscure relevant information and to remember that investors are time-poor and considering multiple companies. Further detail can be provided in ESG datasheets (see page 24). If necessary, such as where you had specific investor queries, being an outlier in your industry, or stakeholder pressure, consider explaining why a factor, issue or metric is not relevant to your company.
- **Ensure a coherent and interconnected narrative backs up the data** – Investors use the front half of the annual report as qualitative context for both the financial statements and non-financial performance. The messaging of your narrative reporting should correlate with the performance reflected by the data and financial reporting to avoid any greenwashing and to maintain credibility.
- **Be clear on scope of the data** – Investors need clarity on whether an issue applies to the whole group or to a specific geography or division to understand how it relates to overall performance. If not reflective of the company as a whole, clearly state what the metric, narrative or policy relates to, or if a part of the business has been excluded.
- **Provide clarity and consistency of location of information** – While some investors say that location of information does not make a difference, clarity of where specific information can be found is critical, especially to data providers' analysts who are searching for information. Also, the location and format of information should remain consistent from year to year as much as possible to facilitate the process for analysts as well as automated data scraping tools. This is not only applicable to reports, but also the company website.
- **Align timing as much as possible** – While it may be challenging initially, aim to provide ESG reporting for the same period and at the same time as the annual report.
- **Simplify content and keep it meaningful** – Reporting aimed at investors and data providers should not be intended as a marketing brochure. Keep photos to a minimum and where graphs or pie-charts are provided, do include the associated figures or percentages. Remember that data is increasingly scraped digitally – interactive websites and documents with large file-size images can be problematic and put pressure on the technology.
- **Aim for comparability of data presentation** – Comparability is key for investors. While data providers will apply a degree of standardisation to company data, companies should aim to use internationally recognised standards and industry frameworks as much as possible in relation to metrics. SASB is widely recognised by investors as a useful framework for financially material ESG issues specific to an industry. It is also a helpful preparatory tool for the expected application of the IFRS Sustainability Disclosure Standards issued by the International Sustainability Standards Board.
- **Prepare for further digitisation** – Although there still is a great degree of manual extraction of data by both investors and data providers, the future is digital. Digital taxonomies are in development for sustainability information and forthcoming standards, so plan ahead to facilitate the process for tagging data and apply lessons learnt from using digital taxonomies for financial reporting.

Using ESG datasheets effectively

ESG datasheets are widely considered helpful by investors and data providers alike. As one easy-to-find repository of a company's ESG metrics and other information, they can greatly facilitate the data collection process.

Format

- Datasheets should be made available in downloadable spreadsheets for ease of access and reduced risk of transposition errors. Ensure they are easy to navigate through a clear and linked contents page, with tabs clearly identifiable and separated by topic.

Content

- Both investors and data providers appreciate when datasheets include all the quantified ESG information, even if this necessitates repetition from the annual report. The ESG datasheet can be a repository for both financially and non-financially material information which is considered necessary to address data providers' requests or different frameworks such as SASB and GRI.
- To identify what to include in the datasheet, analyse the data point requests across your major providers, identify commonalities among them and whether there are any gaps in your existing reporting. If a question is asked by more than one provider, this is generally an indication that investors want that information.
- Consider including submissions to disclosure initiatives like CDP and the Workforce Disclosure Initiative in the datasheet, thus making them publicly available to all users.
- ESG data is not just about metrics but also policies and implementation – consider including a linked index of relevant company policies so they can be easily found, instead of searching across different parts of the company website, and ensure that links are kept up-to-date and any overridden policies are removed from the website. Consider including narrative on implementation and any breaches of the policies where relevant.
- Where including metrics relevant to different frameworks, map them accordingly instead of creating a separate index (e.g. SASB or GRI) which just cross-references to another document. Such cross-referencing is not usually considered helpful and is seen as more of a tick-box exercise – it is more effective and accessible if the specific metrics are included against the required data points than having to go back and forth between different documents or locations in one report for individual metrics.
- Clarify if metrics are estimated when not based on factual data and include a brief narrative on methodology where the latter is not standard practice or as defined in a framework.
- Include historical comparatives for each metric, ideally up to 5 years to enable trend analysis.
- Specify where restatements have been made and whether any adjustments were made to historical comparatives. Similarly, be clear if methodology of a metric has changed and restatements were necessary.
- Be clear on which aspects of the datasheet have been externally assured. Differentiate between different types of assurance obtained, particularly if using symbols to denote this and clearly explain this upfront.
- If data is repeated in other reports, be clear where additional/new information is being provided. Also check for consistency.

Questions for boards

The board establishes an organisation's purpose, values and strategy and should satisfy itself that these are aligned with its culture. ESG data needs are not separate from these goals; they are an enabler of them. Effective organisations set their ESG data collection and information objectives based on what will be useful for managing the business and monitoring its overall performance, not just to meet external disclosure requirements. However, it is also helpful for boards to understand more about their major shareholders and their requirements for ESG data.

Ask:

- How do we engage with investors to understand what ESG data is important to them and why?
- What frameworks are investors using to assess us and our peers?
- Are we engaging with the data providers our major investors use?
- Have we reviewed the ESG ratings awarded to the company by the ratings providers and engaged where necessary? Would it be helpful to include them and add relevant commentary on our website?
- Does our annual report help investors to understand which ESG issues are important to our company and how they relate to our performance, risks, business model and strategy?
- Does our narrative reporting give a sense of our progress towards our ESG goals and correlate with the performance reflected in ESG data reporting and the financial statements?
- Is it possible to align the publication of our sustainability information and to cover the same time period as our annual report?
- Can we put ESG data into a datasheet, which investors can easily access in one place and use to identify trends?
- Have we considered which ESG metrics should and can be subject to external assurance?
- Is it possible for us to map our ESG data to investor reporting requirements, such as SFDR?

Audit Committee Chairs' views on and approach to ESG

A recent YouGov qualitative report, on behalf of the FRC, is based on interviews with 40 audit committee chairs of Public Interest Entities (PIEs) about how they consider ESG issues.

Conclusion

While many investors are primarily obtaining company ESG data via third party providers, how companies report their data will still affect what data flows to the investors. Therefore, to ensure that investors are getting a complete and accurate picture of a company's ESG performance and how it relates to its strategy, companies need to facilitate how they provide data consumed by both investors and data providers. In addition, ESG data is part of a bigger picture and needs to be considered in the context of a company's other reporting in the financial statements and narrative provided in the same reports as the data and elsewhere.

While it may be tempting to provide as much data as possible, companies need to be careful not to obscure what is truly relevant to their business. Additional detail to address multiple requests can be provided in datasheets but in the annual report companies should focus on material ESG disclosures which reflect their company's risks and opportunities and how these impact the business model and strategy.

The Lab's current projects are exploring materiality and business model reporting.

If you would like to take part in future phases of the Lab's work you can email us at FRCLab@frc.org.uk or sign-up to communications from the FRC.

Appendix 1: Regulation for asset managers

- **EU's Sustainable Finance Disclosure Regulations (SFDR)-** SFDR applies to all asset management firms selling products in the EU. Under SFDR, asset management firms must disclose how they have taken sustainability factors into account in their investment process. They must also describe any Principal Adverse Impacts (PAIs) from those investments and classify funds as either Article 6, 8 or 9, according to their characteristics. Article 6 funds are funds which do not consider sustainability factors. Article 8 funds must "promote environmental and/or social characteristics". Funds classified as Article 9 funds must have a "sustainable investment objective".

- **TCFD reporting-** By June 2023 large asset management firms (more than £50 billion assets under management) will have had to report under TCFD for the first time for periods from 1 January 2022. Asset management firms with more than £5 billion under management have to do so by June 2024. These disclosures entail:
  - Entity-level disclosure, which follows the TCFD structure and outlines how the firm considers climate-related risks and opportunities when managing investments;
  - Product and portfolio-level disclosures – Direct greenhouse gas (GHG) emissions (Scope 1 and 2), indirect GHG emissions (Scope 3), total carbon emissions, total carbon footprint and weighted average carbon intensity for each investment product.

- **Sustainability Disclosure Requirements (SDR) -** In October 2022, the Financial Conduct Authority launched a consultation on a disclosure regime for UK asset management firms, aimed at clamping down on greenwashing. It proposes sustainable investment labels, disclosure requirements and restrictions on the use of sustainability-related terms in product naming and marketing. Unlike the EU's SFDR categorisation, SDR is designed to be a label to help investors choose funds which meet their sustainable preferences. The FCA provided an update on the consultation and is currently considering the feedback received and intends to publish its policy statement in Q4 2023.

Appendix 2: Methodology

Participants join projects by responding to a public call or being approached by the Lab. An iterative approach is taken, with additional participants sought during the project, though it is not intended that the participants represent a statistical sample. References made to views of ‘companies’ and ‘investors’ refer to the individuals from companies and organisations that participated in this project. Views do not necessarily represent those of the participants’ companies or organisations.

Views were received from a range of investors, companies, data providers and other organisations through a series of in-depth interviews.

We would like to thank all those who gave their valuable time to this project.

Type of organisation	Number of interviews
Investors - active equity	18
- passive equity	1
- fixed income	2
- asset owner	3
- retail	3
Data providers	10
Companies	11
Consultants	15
Fintech/regtech	11
Academics	4
Others	12
Total	**90**

Reports and information about the Lab can be found at www.frc.org.uk/Lab

Financial Reporting Council

Financial Reporting Council
8th Floor
125 London Wall
London EC2Y 5AS
+44 (0)20 7492 230

www.frc.org.uk

Follow us on
Twitter @FRCnews
or LinkedIn.