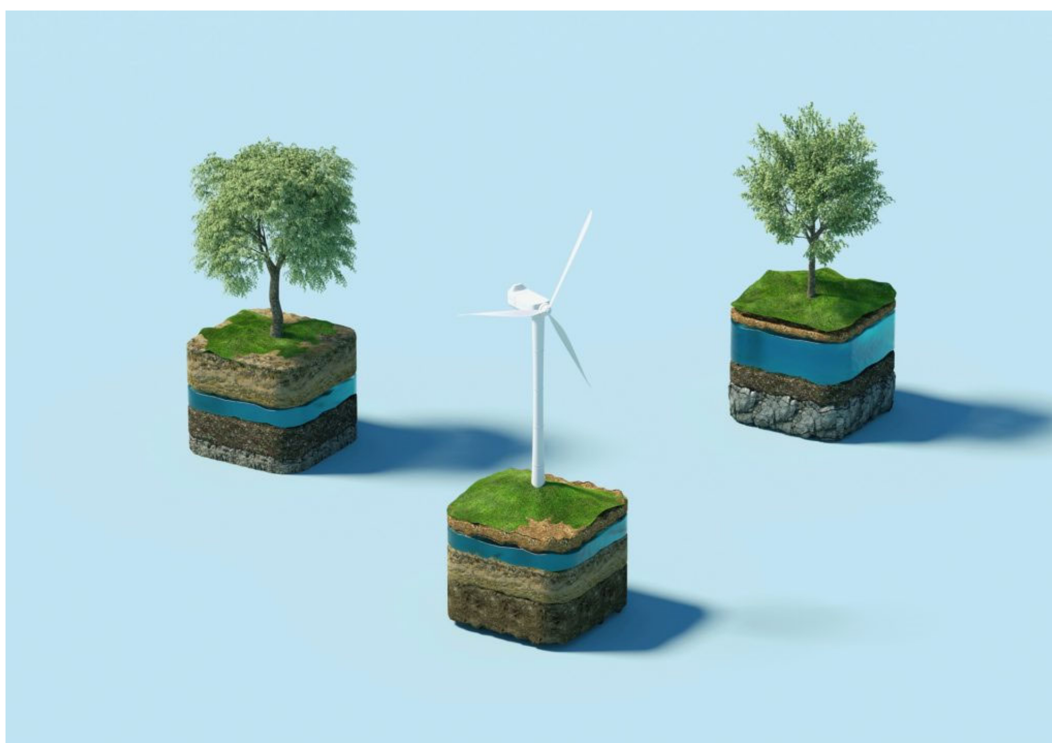
CEF Spotlight

Making ESG Reporting Work for Companies

12/06/20 | CEF Spotlight



By Dan Esty and Tyler Yeargain

More and more investors want better alignment between their values and their portfolios – thus driving expanded interest in corporate sustainability performance as gauged by Environmental/Social/Governance (ESG) metrics. But the existing ESG data frameworks – largely provided by private rating firms such as MSCI, Sustainalytics, Bloomberg, ISS/Oekom, Refinitiv, and others – suffer from a number of structural problems (outlined in more detail below), fail to provide a reliable basis for cross-company comparisons, and therefore don't inspire investor confidence.

The metrics on the sustainable investing marketplace often come from scans of company websites supplemented by corporate surveys. While machine learning and natural language processing continues to improve, the existing data-scraping approaches leave much to be desired. Likewise, the surveys deployed are often less-than-rigorously constructed and vary widely in how ESG issues get framed. As a result, some companies make carefully crafted and meaningful ESG disclosures, while others provide very limited ESG reporting. Furthermore, some corporations follow well-established methodologies in their ESG disclosures, while others report on a self-defined (and often self-serving!) basis.

To add to the challenge, the number of ESG surveys has rapidly proliferated. This reality leaves many companies uncertain as to which ones deserve a response, frustrated by the questions asked (which often

Search...

Categories

Business Case
CEF Research
CEF Spotlight
Circular Economy
Cities
Climate Change
COP21
Employee Engagement
Energy
Finance
Innovation
Low carbon economy
Metrics
Ratings and Rankings
Renewables
Risk
Scenarios
SDGs
Standards
Strategy
Sustainable Business Trends
Transportation
Uncategorized
Valuing Natural Capital

seem burdensomely extensive and sometimes focused on immaterial issues), and suffering more generally from survey fatigue.

Water

More troubling to many corporate sustainability leaders, the existing ESG metrics appear incapable of truly distinguishing between top-tier performers and sustainability laggards – or worse yet, companies engaged in spin or greenwashing. Indeed, the "most sustainable" companies as identified by the top two data providers (MSCI and Sustainalytics) correlate at only 0.30. Some of the problem derives from the fact that there are many dimensions to "sustainability" and wide variations in what people perceive to be the scope and priorities under this banner.

But the lack of a coherent framework of metrics and methodologies for ESG reporting also presents a challenge – as the Esty chapter in the recently published ***Values at Work: Sustainable Investing and ESG Reporting*** explains. Specifically, the existing ESG data feeds too often:

- Lack consistency and comparability;
- Fail to adhere to established methodologies that inspire investor trust;
- Exhibit significant gaps – sometimes not distinguished from low scores;
- Fill data gaps haphazardly and without clarity on the methodologies used;
- Hide assumptions that may shape outcomes dramatically;
- Don't normalize metrics – to ensure "apples to apples" comparisons;
- Lack validation by 3rd parties – again damaging investor confidence;
- Focus on backward-looking issues rather than forward-looking prospects;
- Emphasize risk exposure rather than upside business opportunities;
- Rely on static ("snapshots") indicators rather than trend data;
- Heavily weight reputational scores rather than operational factors; and
- Prioritize "footprints" rather than "handprints" – where companies are helping to solve their customers sustainability challenges.

To meet the needs of the growing community of mainstream investors interested in factoring sustainability considerations into their portfolio choices matters, ESG metrics need to be more structured, consistently defined, and systematically verified. As Cort and Esty observe in their introduction as editors to the ***Values at Work*** book, many investors want broader and deeper ESG reporting. Many also see the *Social* dimension of the ESG reporting as underdeveloped and in need of urgent updating as the "S" issue set has taken on new significance in the workplace in the wake of broad concerns about structural inequality, management and board diversity, pay equity, gender parity, transparency, and customer privacy.

Likewise, the Esty and Lubin chapter in ***Values at Work*** argues that investors need a more high-resolution view of corporate strategy and management's capacity to respond to "sustainability imperative" now facing the business world – including the expanded *Social* agenda that has rapidly transformed workplace norms and expectations and shifted the requirements for marketplace success as society moves toward deep decarbonization and a clean-energy economy. Such disclosure would build on *maturity curves* that gauge the leadership team's vision about the changes ahead for their industry and their ability to refine their business model to position the enterprise to thrive under changed market circumstances.

In the face of these rapidly changing investor interests and ESG reporting confusion, the Securities and Exchange Commission has remained curiously silent, largely leaving it to individual companies to determine what ESG information to disclose. But two Commissioners have signaled a readiness to expand the SEC's required reporting framework to include sustainability issues. The incoming Biden Administration might therefore see an opportunity to take up this suggestion as part of its "all of government" approach to climate change and commitment to address America's racial divide – and could shift the SEC majority with the appointment of a new pro-ESG-disclosure Commissioner.

In any case, the push for a more refined framework of mandatory ESG reporting is gaining steam. The World Economic Forum in collaboration with the Big Four accounting firms has developed a "consultation draft" for a new core set of 22 ESG metrics – building on the work of the Global Reporting Initiative, the Sustainable Accounting Standards Board, CDP (formerly the Carbon Disclosure Project), and the Task Force on Climate-related Financial Disclosure.

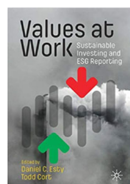
In a similar spirit, we, along with a team of co-authors from the Yale Initiative on Sustainable Finance, have called for a new mandatory ESG reporting framework with three tiers including:

1. A *core* set of about 20 required ESG metrics for all public companies backed by methodological standards for reporting;
2. An additional set of 3-5 *industry-specific* disclosure obligations – recognizing that the material issues in mining will be different from banking and so on; and
3. A structured platform for additional *company-determined* sustainability reporting that would allow each enterprise to offer its own narrative and data analytics.

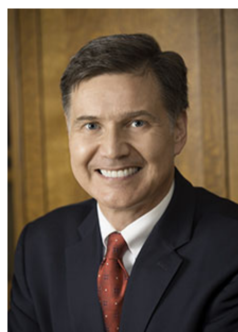
We back up this proposed reform of ESG reporting with four further suggestions to ensure that investors get the sustainability data and information they want and that sustainability leaders can be distinguished from laggards. Specifically, we call for:

- Required 3rd party validation of ESG reporting to ensure data quality and comparability – thus building investor trust;
- Efforts to harmonize ESG disclosure requirements across national borders – to further strengthen comparability and the utility of ESG reporting for investors;
- Creation of sectoral working groups to define industry-specific ESG reporting standards – building on the work of the TCFD, GRI, SASB, and others; and
- Training programs for the key corporate decisionmakers who are responsible for the production, review, and verification of ESG information as well as their legal and accounting advisors.

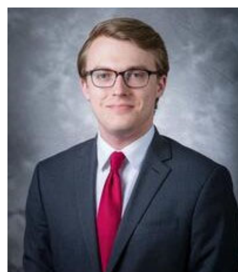
These suggestions provide a pathway to a more sustainable future – where capital flows to companies, projects, technologies, and sectors that are leading the way toward a response to climate change and action on the range of other pressing sustainability concerns. This package would also clarify and simplify ESG reporting requirements, reduce the survey response burden on companies, and ensure that true sustainability leadership will be recognized.



This article draws on ***Values at Work: Sustainable Investing and ESG Reporting*** *(Daniel C. Esty and Todd Cort, editors), just published by Palgrave Macmillan and available here with a 20% discount available to CEF Weekly readers with the code* ***PMP2021*** *as well as a recently released Yale Initiative on Sustainable Finance white paper, "Toward Enhanced Sustainability Disclosure: Identifying Obstacles to Broader and More Actionable ESG Reporting" available here.*



Dan Esty is the Hillhouse Professor of Environmental Law and Policy at Yale University and the author of the several books on corporate sustainability including **Green to Gold** (with Andrew Winston) and **The Green to Gold Business Playbook** (with P.J. Simmons).



Tyler Yeargain is the Associate Director of the Yale Center for Environmental Law and Policy.

« Previous article

© 2020 Corporate Eco Forum. All rights reserved.