U.S. ESG Disclosure Rules Are Coming. Here Are 3 Key Challenges for Investment Managers

ESG disclosure rules are evolving, and there is much uncertainty. While we await further developments in the U.S. and abroad, let's explore potential challenges investment managers may face in complying with these regulations.

ESG reporting has gone from niche to mainstream in the past few years. Voluntary disclosure recommendations are being replaced with required financial and non-financial disclosure regulations. As this trend continues, investment managers may face either a new set of U.S. ESG financial disclosure requirements or enhanced existing regulations and frameworks. Here are three key questions firms should be asking themselves today when facing these challenges.

HOW WILL WE NAVIGATE THE AMBIGUOUS STANDARDIZATIONS?

Even if a firm decides to issue ESG financial disclosures, identifying which standard to apply may be difficult as there are multiple ESG reporting standards and frameworks in existence, such as SASB, GRI, TCFD, IIRC, NFRD, and SFDR. If your company implements multiple standards, you may be challenged with the many different interpretations of data and metrics that produce differing classifications or requirements. For example, deciding whether nuclear power companies are considered green or sustainable could be a point of conflict.

The lack of standardization in ESG ratings poses another set of challenges. A research study by MIT Sloan School found the correlation among prominent agencies' ESG ratings was on average 0.61. By comparison, credit ratings from Moody's and Standard & Poor's (S&P) are correlated at 0.92.

Asset managers could be using multiple rating agencies to either create their own ESG internal ratings or incorporate multiple ratings into their investment models.

WHERE AND HOW SHOULD WE ACQUIRE ESG DATA?

Another area of concern for asset managers is a lack of ESG data. Asset managers rely heavily on publicly available sources of non-financial data needed in their ESG investment processes. Challenges come from the following factors:

- The majority of ESG public data does not contain forward-looking disclosures, putting asset managers at a disadvantage when attempting to model future constituent company earnings
- Lack of current ESG data is a hindrance to asset managers who depend on real-time data in the portfolio management, trading and investment decision spaces
- While asset managers look at earnings and forecasts at a quarterly rate, the public sources of available ESG data are only disclosed once or twice a year
- Besides the frequency of available information, quality can be a challenge as well. According to research from Governance & Accountability Institute, Inc., 92% of companies in the S&P 500 and 70% of the Russell 1000 issued a sustainability report in 2020, but the quality and depth of those company disclosures are inconsistent and lack substance

IS THERE AN IMPACT TO MY OPERATING MODEL?

In preparation for ESG requirements, firms must evaluate their internal operating models and verify:

- Whether ESG metrics are already reported

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IS THERE AN IMPACT TO MY OPERATING MODEL? (CONTINUED)

- If an internal team has claimed ownership of ESG data, including analytics and governance
- How the ESG data is curated and distributed, specifically to investment and risk teams
- There are processes and controls established to generate the ESG reports, validate the information and publish

If your firm is hitting one of the above marks, you are ahead of the curve. Instead of starting from scratch, you will likely only need to modify existing processes as they relate to data models, data sets and controls, disclosures, marketing materials and prospectuses. At the same time, availability of resources, costs and timing may still be major concerns.

Most companies have immature ESG data governance, analytics, processes and controls across the many departments that are needed to generate, validate and publish the data, metrics and reports. If your firm falls in this category, you will face a larger challenge due to the need to possibly acquire new data, new technology to manage, store or analyze the data, establish governance and accountability of the data, and concurrently modify data models. In addition, you may need to create processes to calculate metrics and validate results and build the required disclosures and reports with sufficient assurance and controls of accuracy and quality. The need to constantly engage leaders, managers and staff in ESG to build their skills and knowledge can be an equally challenging task.

The ESG wave is far from over and, while there are more questions than answers at this time, investment managers are in a unique position to evaluate and improve their current operating models.

HOW MERADIA CAN HELP

Throughout Meradia's 25 years in business, the firm has guided investment managers through end-to-end business transformations that ensure technology and operations align with industry standards. Our expert consultants are here to help your firm navigate the operational, data management and performance reporting challenges that arise amid a constantly evolving landscape.

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brings a well-rounded data management perspective to Meradia's global portfolio of clients. Throughout his career, Andrew has supported constituents across the investment management industry, including retail investors, advisors, wholesale teams and institutional investors. He is a seasoned investment professional with diverse experience in business and entrepreneurship, possessing strong acumen of front office operations, data governance and management, and retail client journeys. Andrew's passion for helping people and driving outcomes aligns with Meradia's principles of Perspective, Passion and Impact.

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