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DerivSource Podcast Transcript

Environmental, Social and Governance (ESG): Spotlight on Data

Julia Schieffer: Hello and welcome to the fourth and final episode in our four-part podcast series on environmental, social and governance investing. Today we are looking at how data impacts the ESG space. And with me, I have Chris Johnson of HSBC Securities Services to talk about how the firm is analysing third-party ESG data to support its clients with reporting and measurement. And we're also talking about how the EU development of ESG taxonomy could impact this space going forward. Welcome to the podcast, Chris.

Chris Johnson: Thank you Julia.

Julia Schieffer: And Chris, before we begin, can you tell us a little bit about yourself?

Chris Johnson: Hi Julia. Yes, I've been working for HSBC Securities Services in product management over the last 10 years. First of all, following the financial crisis where we were looking at asset pricing in particular and then onto regulatory data. And now for the last two years, my main priority has been how we develop products to support the evolution of environmental, social and governance investment, also known as sustainable and responsible investment.

Julia Schieffer: So before we get into the topic today of this podcast, which is really looking at the data side of ESG, can you give us a little bit of background starting with what ESG is?

Chris Johnson: Absolutely. So ESG. The context here is environmental, social and governance. So this is something which has been around for some time. So focusing on environmental considerations such as greenhouse gas emissions and deforestation, waste and pollution, social such as working conditions, health and safety, local communities, governance such as executive pay, political lobbying and tax strategy and so forth. And the types of strategies - there are a number that I pick out. The first time I'd pick out is exclusions, where the strategy is to exclude certain companies from a fund for example, based on certain criteria such as, for example, a weapons manufacturer or tobacco or alcohol based on the revenues. Another is engagement in voting where an asset manager will engage with the company on sustainability matters. Another is integration of ESG into investment. And another is penultimately I would pick out sustainable investment themes. And then finally impact investments where the purpose of the investments is to generate a specific positive social or environmental impact.

Julia Schieffer: And going into a little bit about HSBC, can you tell us what HSBC Securities Services has done?

Chris Johnson: We've spent the last two years as a priority analysing ESG data and performing comparisons across the different types of information that's available from third-party providers to compare those to see which can be used as crunchy measurements to help us support our clients with reporting and measurement. We've carried out two large scale exercises to compare that information and we've reached our conclusions and we've learned a huge amount about what is available today.

Julia Schieffer: And in your view, what has HSBC Securities Services learned so far?

Chris Johnson: It's been absolutely fascinating, Julia, what we've learned on our journey so far and our key finding is that ESG measurements that are available are non-financial, opinion-based, representing research assessments of companies. So that means that there's a large variability between how each of the different companies rate a company and an investment as to whether it's highly or poorly rated using ESG criteria. We found in our analysis that 30% of the assets could be either highly rated or poorly rated according to the different suppliers. And it's really hard to see how that will converge. So therefore, this is really confirming what our clients have told us, those who have the expertise in the investments and also what we've learned from the market. And there are lots of press articles that back this up and surveys. So, we've evidenced that. At conferences, I've asked the question as to how many years it will take for non-financial ESG measurement to catch up with the world of financial data, which we know so well. And the estimates I've heard are anything from five years at best, if there's a lot of investment and a lot of regulatory stick, up to 20 years. So, it's really quite at its early stages, but we've understood the fabric of what there is today for ESG from our analysis.

Julia Schieffer: And talking about evolution, obviously the regulation side plays a big part in this evolution. What are the regulators doing in your view?

Chris Johnson: The regulators are doing a lot, particularly in Europe, and they have recognised that there are challenges with ESG data, but they're rightly pressing ahead to encourage sustainable investment. The European Union is proactively developing an ESG taxonomy. This taxonomy is going to be largely focused on climate at this stage. It's a large-scale exercise. It will take time and it will, from what we can see, be done thoroughly and properly and be supported. So, the regulators are certainly very concerned to make sure that sustainability is encouraged and that it is done properly and that the measurements are established to make sure this is on solid ground.

Julia Schieffer: So, in looking at the investment side, what are the drivers for ESG Investment?

Chris Johnson: Yeah, we're seeing a great deal of activity in ESG. We're finding that our clients are asking about ESG in many of the meetings that we have regularly with our clients. It is a hot topic and recognized as such. We think what's driving it is a number of things. The United Nations clearly with the Principles of Responsible Investment and very many of our clients have signed up to those principles. And the PRI is active in following that through. The United Nations Global Compact, the COP24 at the end of last year. And there's another one, due at the end of this year. So the United Nations very much at the forefront as we've already discussed, it's clearly a regulatory priority. And then as far as the demand is concerned, whether it's retail demand that places expectations not only on asset managers but really to insurance companies and pension funds as well. And the last thing, which is something which is possibly quite contentious, and we wouldn't give any opinions on this, but there's a lot of focus on the potential for greater long-term investment returns. And there's a lot of analysis taking place to try and evidence this.

Julia Schieffer: So looking at ESG and data specifically and getting into some of that detail, what are the types of ESG data that's currently available?

Chris Johnson: Well, Julia, the types of data that we have seen, and we found in our analysis of what's available, we found three. There's ESG scores and ratings where a company is measured based on its ESG credentials. There's carbon emissions, which is a standard about greenhouse gas emissions from that company and there are Sustainable Development Goals (SDGs), which are from the United Nations. And there are measurements of SDGs, sustainable development goals, which are becoming more available. As far as the level of maturity of these and usability, the ESG scores and ratings are very established. There are a dozen or so providers that provide ESG scores and ratings. However, as we've already discussed, these have multiple different methodologies and different results. They're very variable. It could be that the EU taxonomy will deliver such thing as an 'eco' label over the next few years, which will help to produce some standardization, but we're not seeing that yet. The second, carbon emissions, is factual and this is a standard. However, there are issues with coverage and some of the companies are producing estimates to make up for that and we are seeing variability. But that is an area very much to focus on because that is fixable. And then the third, SDGs, it's still quite early days. But this is an interesting one because it could be something that is more investor friendly and more real to investors. So that's a very interesting one for us to follow.

Julia Schieffer: So, you've touched a little bit on regulation already. Looking at that in a little bit more detail, what regulation is out there and what are the possible considerations and changes?

Chris Johnson: I think regulation is very much the key for the evolution of ESG measurements as far as prescriptive regulation and expectations for reporting. As I may have mentioned earlier, the areas we're looking at for measurement in the post trade area, we've looked at regulation, and where regulators in the past, for example, with MiFID and Solvency II, where they prescribed certain types of reporting, we're not yet at that stage with ESG. So, any reports that we produce now, we'll be pre-empting what that prescriptive reporting may be in the future. So far as I've mentioned, the EU taxonomy with the consultation is actually taking place at the moment in quarter three of 2019. In Hong Kong, the **Securities & Futures Commission (SFC)** produced a circular with a guidance note stating that a fund adopting ESG screening strategies or thematic investment strategies should demonstrate that at least 70% of its total net asset value is invested in securities or other investments reflecting the stated green or ESG related investment focus. In the UK, the Department of Work and Pensions has a requirement for UK pension funds of a certain size to consider ESG within their investment strategy from October this year. And as far as the banks and insurers are concerned, the Bank of England is looking at climate scenario testing requirements for those. In the United States, there are a number of states that are pushing ESG, such as California, Massachusetts, Washington State and New York. So, the regulators are aware that this is challenging, but nevertheless, as the regulators form reporting requirements, that will help to drive forward ESG data.

Julia Schieffer: So, regulation is pretty crucial to the evolution of the data side of ESG, which is pretty necessary to support the evolution of ESG itself.

Chris Johnson: I think that's exactly right Julia.

Julia Schieffer: So, we've talked about ESG, which is obviously a popular trend but very important for both investors and for investor service providers such as HSBC Securities Services. My final question to you is looking at maybe some of the risks and opportunities for this trend, do you have any views on the risks or potential opportunities?

Chris Johnson: Yup. I think there are certainly a lot of opportunities, and the opportunities were, for example, one of the areas we haven't covered so far is green bonds. And the increase in issuance of green bonds is obviously very positive. And it's getting to the point where green bonds are becoming a material bond issuance category and ESG exchange-traded funds, we're seeing those emerging more. There's an emphasis on private assets, such as private equity infrastructure and property, where the outcomes of the investments can be targeted towards impact investment and specific outcomes. We're also interested - another positive aspect is where the credit ratings agencies are moving into ESG and the likes of Moody's, Fitch and Standard and Poor’s. Moody's, earlier this year bought the Vigeo Eiris ESG research company that produces information. Standard and Poor’s have announced how they are producing more ESG measurements and equally Fitch.

And I'm sure the same will be true for other credit rating agencies. And I'd also include in that the emergence of ESG futures contracts. And as we've seen and as per DerivSource publications earlier this year, there are futures contracts that are emerging, which will be another tool for investment in ESG. As far as the risks and the cons, we've been really very concerned within HSS to make sure that we've really kicked the tires on ESG before we go in and produce products. And so, what I've said earlier in this discussion about the ESG measurement and the consistency, we will live with that inconsistency that exists and we'll make sure that's clear in everything that we do. As there become more common standards that will make it easier for us to treat this as a traditional type of a reporting service for our clients.

Chris Johnson: The final area of risk and consideration that I would pick out to conclude my comments on this podcast are the variability of ESG from the many different providers will mean that the formation of new ESG indices will be equally variable. So, there will be instances where you could have a new index for ESG that is different from another, even though the purpose of that index is similar or identical. So, whereas with financial indices, they are doing identical things with identical measurements, in the world of ESG, because the measurements are based on research opinions, it could be that one index is different from the other index and over a number of years that could lead to two different outcomes for that index.

Julia Schieffer: So basically, consistency is key going forward, but there has to be a lot of work in order to get there for this industry.

Chris Johnson: I think it's really important for the investment world to understand how ESG is different from anything we've seen before and to embrace that difference and understand it and make sure that's communicated all those people who invest in ESG strategies.

Julia Schieffer: We've covered ESG in various different guises in this podcast and articles, but we've had quite a bit of interest from our audience about the data side. So, thank you very much Chris, for sharing your expertise with us on this very, very timely topic.

Chris Johnson: As always, it's my pleasure, Julia.

Julia Schieffer: Thank you for listening to this DerivSource podcast. We hope you found it informative and useful. You can find related resources on our show notes page on derivsource.com and please consider subscribing on iTunes. Thank you for listening. Join us next time.