FINANCIAL SERVICES

PUT ESG PERFORMANCE INTO SHARPER FOCUS

ESG PERFORMANCE—FACT OR FICTION?

In the past decade, sustainability has become more than just a buzzword among environmentalists – it's now a critical mandate for businesses with trillions of dollars of investments on the line. However, developing metrics to track the success of green investments has proven to be extremely difficult. This has created concerns about the potential for companies to make false environmental claims, whether knowingly or unknowingly.

Assessing the success of a company's environmental, social, and corporate governance (ESG) initiatives is essential to guiding green investment decisions around everything from climate change to energy transition. It's also important for gauging a broader range of non-financial risks to companies in a complex business environment – and for making decisions about how to drive sustainable growth in the 21st century.

Accurately measuring the success of companies' ESG initiatives is especially important in the financial services industry. In 2021, a group of banks, insurers and investors holding a collective $130 trillion pledged to make combating climate change a key part of their businesses and to promote green investing.[1] From 2012 to 2021, green financing – in the form of environmentally-focused bonds and loans – increased by more than 100 times, rising from $5 billion to $541 billion.[2] By 2025, ESG investments are expected to account for 15% of all investments.[3]

Despite their importance, ESG measurements are often unreliable, with ratings from third-party reporting agencies varying significantly. This opens the door to greenwashing, in which ESG measurements paint an overly positive picture of ESG performance. Greenwashing is sometimes done intentionally by companies to give consumers and investors an inflated sense of their ESG accomplishments. Quite often, it is done unintentionally due to shortcomings in ESG-related processes and data.

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The lack of reliable, transparent, and consistent ESG ratings undermines their effectiveness and credibility. In 2022, such ratings inflation led Morningstar to find that more than 1,200 ESG funds accounting for $1 trillion were no longer qualified to receive the ESG designation.[4] As these reports continue to make headlines, they erode trust in ESG efforts overall.

All of this creates challenges for the financial services industry – for the fund and asset managers, bankers, research analysts, and loan and insurance-policy analysts trying to meet the growing demand for ESG-related investments and products. The lack of reliability of ESG ratings also increases the risk to banks and other financial institutions of litigation related to claimed greenwashing among companies in which they invest or insure.[5]

None of this is to say that today's ESG ratings and metrics are not valuable. They provide a valuable tool to measure baseline performance. However, there is substantial room for improvement. As the world moves toward investing trillions of dollars in companies based on their ESG ratings, the urgency around this issue will only increase.

What's needed is an innovative approach to using ESG data and technologies such as artificial intelligence (AI), natural language processing (NLP), and machine learning. When done right, this approach can bring more rigor to the management of data – which in turn will increase the consistency, quality, and business value of ESG assessments.

1 "COP26 coalition worth $130 trillion vows to put climate at heart of finance," November 3, 2021

2 "Global green finance rises over 100 fold in the past decade -study," March 31, 2022

3 "ESG Investment Expected to More Than Double in the Next Three Years New Research from Dow Jones Shows," September 7, 2022

4 "ESG Funds Managing $1 Trillion Are Stripped of Sustainable Tag by Morningstar," February 10, 2022

5 Claire Nightingale, "Banks are exposed to Climate Change claims: the litigation begins," Lexology, March 15, 2023.

THE CHALLENGE OF DIFFERING ESG REALITIES

There are a variety of drivers behind the lack of reliable, consistent ESG data. For one thing, ESG performance itself is not yet well defined, leaving much of it open to interpretation. Notably, a cigarette manufacturer recently received a better ESG rating than the electric vehicle manufacturer Tesla. Similarly, one rating company recently gave FTX, the failed crypto currency exchange, a higher score on leadership and governance than Exxon/Mobil.[6]

Certainly, intentional greenwashing further muddies the waters. However, this is overshadowed by the way even well-intentioned companies develop their ESG data. This data is typically kept in silos, and there is often little rigor in the processes used to identify and aggregate that data – or to scrutinize it for accuracy. Overall, companies typically struggle to develop a central view of their ESG data. The self-disclosed data that comes from this process is fed into downstream users and processes, such as third-party ESG ratings agencies and financial services companies trying to assess ESG performance.

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At the same time, there are more than 50 ESG data and ratings providers, including major firms such and Moody's, S&P, and Fitch; market data providers such as Bloomberg, MSCI, Refinitiv, and Sustainalytics; and other small startups.

All of this creates obstacles for investors, both retail and institutional, trying to make decisions about where to put their funds, and for policymakers trying to oversee corporate behavior. For financial services companies, it makes it difficult to understand the real ESG performance of companies and portfolios; assess ESG risks and losses; and ensure that they have the data needed to comply with changing regulations.

It is common to hear financial services companies complain about inconsistent ESG data. In a 2022 Dow Jones survey of financial leaders, two thirds of respondents said that ESG investing is a top driver of sustained, long-term growth. Yet, 52% said that the quality of today's ESG data is not yet good enough to support investment decisions, and 58% said that greater transparency into how ESG ratings are developed is needed.[7] Financial institutions should consider third-party ESG ratings as simply one tool to measure performance and need to leverage additional sources to validate and augment these scores.

[6] "FTX And ESG: A Panorama of Failed Governance," Forbes, November 22, 2022

[7] "ESG Investment Expected to More Than Double in the Next Three Years New Research from Dow Jones Shows," September 7, 2022

EXPAND THE HORIZONS OF ESG DATA

These issues have led to a loss of confidence in ESG claims. For example, in a 2023 survey of its in-house analysts, Fidelity International found approximately 60% felt that the ESG credentials of the companies they follow are not backed up by concrete actions.[8] To address such problems, financial services companies need to take a different approach – using both structured and unstructured data – that combats greenwashing by comparing ESG pledges and claims to actual actions and progress. This new approach begins with structured data, such as from third-party ESG providers and financial reports. It also goes a step further, drawing on a natural language processing (NLP)-enabled sentiment engine to assess a broad range of unstructured data from such sources as social media, global news, shareholder proposals, litigation documents, and investigative articles in the media.

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There is vastly more unstructured data than structured data in the world. This wealth of data is used to validate and augment the traditional structured data to provide a deeper, more-accurate perspective on a company's ESG-related risk, activities, and progress. For example, a company may report that it is doing well on the social component of ESG, but unstructured data, such as local reporting from around the world, might indicate that its overseas suppliers are engaged in prohibited employment practices. Such insights can be factored into a sentiment engine's analysis that classifies information into positive, negative, or neutral categories to provide a deeper understanding of ESG performance.

NLP has its limits though. For example, NLP is often unable to identify statements that are simply PR or promotional that could greenwash actual ESG performance. The technology may lack the common sense needed to understand such nuanced information – and in fact, most sentiment analysis tools struggle to differentiate good events from bad ones when looking at unstructured data.

To address that problem, an ESG-focused sentiment engine can draw on AI and machine-learning technologies and techniques to constantly learn and improve its ability to analyze such information, providing a deeper, more accurate understanding of unstructured data. With this type of AI-powered sentiment engine, companies can develop insights into ESG performance in real time – and when needed, quickly drill down to explore the underlying elements of that performance. The result is the ability to look beyond the black box of agencies' ESG ratings in near real time to see what is occurring at a company, increasing the effectiveness of financial services companies' efforts to gauge ESG performance. In addition, with the use of analytics, this approach can be used to take a more predictive look at ESG risks.

[8] Mark Segal, "60% of Analysts say Companies' ESG Claims not Backed up by Action: Fidelity Survey," July 5, 2023

FOCUS ON THE PURPOSE

The NLP-based approach provides a number of benefits, but it can be further enhanced by the creation of various lenses – that is, versions of the NLP technology and sentiment engine that are tuned to focus on specific purposes. Such lenses could help in the following areas:

TRACK COMPANIES' ESG EFFORTS FROM AMBITION THROUGH ACTION

Central banks, stock exchanges, and central securities depositories can create searchable ESG repositories of non-financial corporate reports that can be powered by NLP. These can enable organizations to quickly understand a given company's ESG pledges, activities, and key ESG performance indicators, while also monitoring how well the company is progressing toward achieving their aspirations.

SPOT GREENWASHING

Financial services companies can check self-reported ESG claims or agency ratings against a range of public information and unstructured data sources to uncover inconsistencies and exaggerations in ESG data. This can include the benchmarking of reports against industry frameworks and the ability to drill down into the factors underlying claims and ratings and compare them with data from alternate sources. This lens helps ensure consistency and accuracy in investment or fund management and underwriting analyses.

COUNTER BIAS IN NEWS AND MEDIA REPORTS

This approach refines NLP to understand nuanced good and bad sentiments more accurately across thousands of unstructured data sources, providing a clearer view and proper classification of media reports to break through the noise of reported ESG-related events. This allows traders, fund managers, and others to analyze underlying details and accurately understand the nature and impact of these events, and then respond to them quickly and proactively.

FILL IN AND AUGMENT DATA GAPS

In some regions, such as Africa and southern China, there is a limited amount of available ESG data from third party data providers. The same is often true for certain business segments, such as small and medium businesses. However, by drawing on unstructured data sources to develop insights into such companies, investment banks can develop proxy data that paints a picture of ESG activities, which can be factored into investment banks' analyses.

ENHANCE INSURANCE LOSS PREDICTION

The use of unstructured data can significantly enhance risk assessments for companies that underwrite directors and officers insurance. For example, these insurers can use ESG litigation data, SEC filings, news reports, and articles to augment traditional structured data. They can thus gain a fuller view of potential problems involving everything from social concerns to environmental issues by correlating signals and sentiments from negative screenings, and factor this view of risk into their pricing. At the same time, they can monitor ongoing, dynamic ESG risks and expand this capability into loss prediction models.

ENSURE REGULATORY READINESS.

The regulatory landscape and industry frameworks around ESG are evolving, and in many countries, shifting from a voluntary to a mandatory approach. Compliance will rely on having access to ESG-related information. With an NLP-based approach, financial services companies can have an overview of their data readiness for compliance and know what data they have and what external parties can fill in the gaps. They can track which regulations and frameworks are applicable to them and help ensure that their data strategies are aligned with the changing environment, enabling them to respond to queries from regulators with structured data analysis.

MORE DATA YIELDS GREATER PAYOFF

Individual companies can use this capability as both a window and a mirror for measuring and managing their own ESG performance. As a window, it can enable them to look beyond the ESG claims of suppliers to gain a clearer perspective of the actual ESG-related risks and activities of those partners – and identify any supply chain risks that might have a negative impact on their own performance. Meanwhile, as a mirror, it provides a valuable outside-in view of the company's ESG performance – one based on a broad range of external data that transcends the traditional siloed pools of data they have used to track ESG metrics.

This approach can also benefit the broad range of financial services companies that use ESG data to guide their investment or underwriting decisions. It can enable them to quickly identify inaccurate ESG claims or uncover discrepancies in reports from companies and ratings agencies by correlating litigation data with loss prediction – and drill down to find the underlying reasons for those differences.

Capgemini has helped several financial services companies take advantage of this type of approach to ESG data. For example, we worked with an investment bank to create a near real-time ESG sentiment system that integrates more than 70,000 global news sources and enables traders to quickly understand the impact of events on the ESG profile of companies. We are also helping a central bank augment its ESG data repository with unstructured data and searchable ESG key performance indicators to enable rapid ESG performance insights into parties in transactions.

In addition, we are working with a stock exchange to use an NLP engine to leverage unstructured data and fill in gaps in ESG data for certain geographic areas and industry sectors to support an open ESG marketplace for green tech providers. Ultimately, such efforts demonstrate the ability of an NLP and AI-powered ESG sentiment engine to help financial services companies make more informed decisions about a given company's ESG performance.

ATTAIN YOUR ESG GOALS WITH CLARITY AND CONFIDENCE

These are just a few examples of how the application of different lenses can tackle key ESG metrics and decision-making. Financial services companies can create more lenses as more ESG related challenges and opportunities emerge. Ultimately, organizations may find themselves using a suite of lenses to support their ESG efforts.

The ability to flexibly expand and reshape an organization's AI- and NLP-enabled approach to ESG will be critical. ESG considerations are likely to continue to play a growing role in business and investing – and thus, for financial services companies.

The financial services firms that can harness a broader range of data to develop deeper insights into ESG performance will benefit more fully from the ongoing shift to ESG – and help society achieve a range of key goals in the years to come.

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