

Meeting the Data Challenges of Europe's ESG Regulatory Landscape



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Introduction

The European Union has gone further than any jurisdiction in enacting rules to ensure transparency in sustainable finance markets. Its European Green Deal established a set of regulations under the EU Action Plan on Sustainable Finance (EU AP) that are designed to ensure private money is efficiently targeted to the companies and projects that can achieve the 27-nation bloc's sustainability goals – establishing a cap on rising global temperatures and healing social wounds in line with the United Nations' Sustainable Development Goals (SDGs).

The most far-reaching of these are the Sustainable Finance Disclosure Regulation (SFDR) and the EU Taxonomy, which oblige financial market participants to identify which of their investments and activities contributes to the EU's targets and explain the impact they are having on the communities in which they operate and the world in general. Similar rules will be introduced for other companies under the Corporate Sustainability Reporting Directive (CSRD) legislation that extends from the Non-Financial Reporting Directive (NFRD).

The multiple facets of these regulations will be introduced over time to give reporting companies room to digest and prepare.

For the first time in a set of supra-national ESG reporting rules, SFDR, Taxonomy, NFRD and CSRD have also crystallised the important role that data plays in the process of bringing about climate and social change – and in mitigating the activities that deepen those problems. New data sets, new insights and new ways of gathering that information will be needed for financial institutions to comply with the EU ESG regulations.

(For a timeline of the regulations' formulation and implementation, see Appendix 1.)

Only by harvesting these growing and new forms of data can market participants provide the information that regulators require. That data will also offer the insights, and reveal the trends, that investors will need in deciding how to put their money where it will have the most impact.

And it's on data that the EU regulators' intentions will depend for success.

FINANCIAL INSTITUTIONS AND ESG

The draughters of the European Union's green regulations set out to create a common reporting framework for companies to disclose their ESG performance and provide that information to investors so that they can make decisions that would funnel capital into the sorts of projects that bring about the EU's sustainability goals.

The EU Taxonomy provides a framework for codifying whether a financial product, business activity or investment can qualify as sustainable. To qualify as sustainable and align with the Taxonomy, an activity or investment must contribute significantly to one of six environmental objectives, do no significant harm to the other environmental objectives, and comply with minimum safeguards.

SFDR aims to make the sustainability factors of funds and investments understandable and comparable by requiring financial institutions to declare the ESG performance of their investments and activities in periodic reports, on their websites and in pre-contractual disclosures.

Sustainable Assets

Not too long ago, sustainable finance was the preserve of development banks, which sought to alleviate the direst problems in specific parts of the world. In the past decade, however, such financing has grown out into the broader private markets.

Companies, driven by consumer choice, have identified value in offering goods and services that are seen to have a positive impact on the environment and society. For investors, these companies and their assets are viewed positively because such sustainable activities contribute to reducing the company's exposure to physical risks associated with climate change and environmental degradation, as well as reputational risks linked to social inequalities and divisions. Together these characteristics provide the assets with a green premium, or "greenium". The International Institute for Sustainable Development [estimates](#) that assets managed under an ESG mandate will total \$160 trillion by 2036.

Another reason why sustainable investing has grown in popularity was highlighted by a 2015 report by consultancy firm McKinsey. [Delivering Through Diversity](#) found that companies in the top quartile for gender diversity – a key gauge of responsible corporate governance (CSR) – were a fifth more likely to have above-average profitability than those in the bottom quartile. For ethnic diversity, that figure was 33%. Additionally, a report by Gartner indicated that three-quarters of IT companies with diverse decision-making teams were likely to beat their financial goals.

The conclusion is that responsible corporate behaviour makes for good business.

A key intention of both the EU ESG regulations, is to prevent the deliberate mislabelling and selling of assets as sustainable to raise their profile and appeal to investors looking for a real sustainability impact. This way the EU can strengthen the ESG market and smooth progress towards achieving international sustainability goals.

While green bonds benefit from their ability to bring needed change, what of those other "vanilla" assets that are subject to the outcomes of climate change and social division – such as flooding, wildfires and racial strife? Or those activities that contribute to the problems – including oil drilling and deforestation.

The regulations recognise that while the creation of vehicles that have a material beneficial impact on the world is important, it is equally vital to provide for the identification of the sustainability risks to which companies and their assets are subject.

THE DATA CHALLENGE

Scope of the Regulations

The EU Taxonomy and SFDR are the single-largest pieces of ESG-related legislation introduced anywhere in the world, and their compliance requirements are equally daunting.

Market participants are already expected to report their Level 1 disclosures under SFDR. These are declarations on the level to which their investments and activities can be regarded as sustainable, according to the framework set out by SFDR and the Taxonomy. Level 2 disclosures, which are expected to come into force at the beginning of 2023, will oblige disclosing institutions to provide far greater detail on the how and why they have made their Level 1 declarations.

From a data gathering and analysis standpoint, these requirements put enormous responsibilities on financial institutions.

In the case of greenhouse gas emissions reporting, this will become all too apparent when the regulators move beyond requiring the disclosure of companies' own carbon footprints to those of their suppliers and customers. This will be challenging. Many of those companies, especially supply-chain services providers, are unlikely to be subject to the Corporate Sustainability Reporting Directive (CSRD) – which will require non-financial companies to make similar disclosures required by the SFDR. But if those companies feature in investment portfolios, then financial institutions still will be expected to disclose their ESG performances.

The net effect is a greater need for accurate, high-quality and timely data.

Finding the information to show an entity is aligned with the Taxonomy (it requires the interrogation of revenue, capital expenditure and operational expenses).

A look at the Taxonomy's six objectives indicates the complexity of the data task ahead:

1. Climate change mitigation; *
2. Climate change adaptation; *
3. The sustainable use and protection of water and marine resources; **
4. The transition to a circular economy; **
5. Pollution prevention and control; and **
6. The protection and restoration of biodiversity and ecosystems. **

(*Already applicable; ** Applicable from January 2023)

Once all objectives are in force, market participants will need to obtain and manage data they are unlikely to have readily on hand. They will include disclosures on:

- Climate: Greenhouse gas emissions; exposure to companies active in the fossil fuels industry; use of renewable energy sources.
- Environmental impact: Activities' effects on biodiversity; water usage and impact on scarcity; production of hazardous waste and pollution.
- Social impacts: Compliance with UN and Organisation for Economic Cooperation and Development (OECD) guidelines on corporate behaviour; gender parity and diversity; exposure to controversial weapons.

The regulations apply to all investments, including funds and other financial products that are aggregated from a broad pool of assets from multiple issuers. Having a way of obtaining the data to accurately reflect the opportunities and risks inherent within them will require specialist capabilities that include engagement with the many manufacturers of those financial products.

The task will not be made easier by the fact that the Regulatory Technical Standards (RTS), which provide the detailed blueprint on compliance standards, was only approved in February 2022, giving market participants little time to fully implement their data collection processes. The standards are being introduced over time, with the process expected to be complete by the end of 2022.

Breadth of Data Required

Despite delay in the publication of the RTS, it's long been known that the breadth and nature of the non-financial ESG data required for SFDR compliance will make its collection and disclosure a huge challenge.

The regulation is intended to lift transparency and accountability in investment management to a level not seen before. It seeks to achieve this by asking companies to report on the Principal Adverse Impacts (PAIs) of their activities.

(For the list of mandatory Principal Adverse Impact indicators, see Appendix 2).

These are defined by the European Securities and Markets Authority (ESMA) as:

“Negative, material or likely to be material effects on sustainability factors that are caused, compounded by or directly linked to investment decisions and advice performed by the legal entity.”

There are 14 mandatory PAI indicators that must be reported, ranging from greenhouse gas emissions to human rights records. There are many more that companies can disclose at their discretion. Companies will be expected to make a PAI statement in a templated format and disclose relevant information at the entity and product levels in multiple languages.

This is expected to be introduced with detailed Level 2 disclosures at the beginning of 2023.

PAIs are a highly detailed and prescriptive set of requirements that will mean market participants – and their advisers – may need to source data from several providers to give them the broadest visibility. That places new administrative processes on companies, who can be expected to update their IT and maintenance systems to accommodate this surge of information onto their systems.

Ingesting the data is one issue, managing and applying governance structures over it is another. ESG data is not like price and other reference data, for which most financial institutions have long-established data management processes. ESG data must first be standardised and structured so that it can be integrated with financial data, included in regular reports and made ready for further processing by artificial intelligence (AI) and other sophisticated software.

Collating, aligning and organising ESG data into the correct classifications can be difficult when dealing with multiple sources, which may work to different methodologies and frameworks. That information also must be combined with the reporting company's own collected data, from order and portfolio management systems, for instance. This may not be readily aligned with the bought-in data.

Hitting all the data points required by SFDR will oblige companies to make some of their own calculations and build their own ESG models.

Incomplete Picture

Once vendor contracts have been agreed, there comes another significant issue: not all the data needed to comply with SFDR is available. While market participants will seek to establish a patchwork quilt of sources that can cover the broadest range of datasets, they may not be able to incorporate the totality of data expected by the regulators. This would be more pronounced among smaller financial companies that are unable to afford a more comprehensive suite of data feeds.

An added complication is SFDR's requirement for asset and portfolio managers to disclose the ESG performance of the companies in which they are invested. This may not be an issue if the investee company is listed and has adequate reporting structures of its own. However, portfolios are made up of a variety of assets, including those of private companies and real estate for which there is often little available ESG data. One reason for this is that NFRD, and in future CSRD, only requires larger companies to make such disclosures.

Gaps in the data also exist because of the difference in geographical embrace of ESG disclosure regimes. In Asia Pacific, for instance, only companies listed in Hong Kong or Singapore are subject to disclosure rules. Even in the US, the extent of such reporting is still being determined.

Europe-based financial institutions holding assets from regions with more limited ESG performance reporting records – or even lacking the data related to local holdings – will be forced to seek workarounds. They are doing this in a variety of ways; by engaging directly with their investee companies and advising on their joint disclosure obligations; or, by using proxy data and estimated data, which is often derived from alternative data sources that must be processed through software.

This issue is expected to be partially addressed when the non-financial equivalent of SFDR – the Corporate Sustainability Reporting Directive (CSRD) – comes into force.

Show and Tell

Currently, when companies are unable to furnish regulators with the necessary disclosures, SFDR permits reporting companies to demonstrate they made their best efforts to secure it. This requires them to give insights into what data and measurements were used and how it was gathered, even showing which vendors were engaged.

Should companies change their data coverage strategies, they must also give reasons why and show that the new arrangements are just as comprehensive and effective in enabling disclosures as the previous ones.

CONCLUSION

The requirements of ESG reporting are growing at a rapid pace and nowhere more so than in the European regulatory space. While the European Commission and its working groups that forged the SFDR and EU Taxonomy have not yet spelled out the exact penalties for non-compliance, they are expected to be severe. Large fines and even sanctions along the lines of those imposed by the Markets in Financial Instruments Directive (MiFID) have been suggested as likely by some observers.

The commercial benefits may be even greater. Consumers, investors and lenders are more likely to be attracted to a company's dedication to the ESG cause, rewarding them with their capital and patronage.

Getting compliance right, then, is going to require many things – among them planning and vigilance – but above all it's going to need data, good quality, clean and useable data. Selecting the right provider will be critical to that mission.

Only with a reliable and trusted source of data can companies hope to fulfil the requirements of ESG regulatory compliance. Some companies, doubtlessly, will try to construct a setup by themselves, contracting vendors and establishing new feeds in a piecemeal manner. That route is fraught with problems, not least that of finding the exact data needed.

The most elegant strategy is to establish a single point of contact, a single pipeline and a single source of data. Eliminating complexity increases efficiency; the simplicity of a unitary setup provides the flexibility, scalability and reliability that's essential today and that's going to be needed long into the future as the regulatory landscape evolves and companies are compelled to offer more and better data.

HOW SIX CAN HELP

It's clear that financial institutions falling under the regulations that haven't already put in place robust and effective data strategies to comply with the EU Taxonomy, SFDR and their associated regulations must do so quickly.

- They will have to reassess how they obtain their ESG data, bearing in mind that the ESG landscape is new and fast changing. The amount of information they'll need is likely to grow over time and they will probably need multiple data feeds to cover their needs.
- They will be required to consider the data management and quality implication the regulation will impose, having in place a reliable means of standardising a range of data types to integrate into their vanilla information feeds.
- The changing nature of regulations in Europe will place an expectation of process agility on market participants to ensure their systems and infrastructure are updated and ready to absorb the new data feeds and models as compliance expectations change.

Executing these transformations would put great operational and financial strain on a large majority of market participants. For that reason, a better route would be to engage a company with a tried and trusted record in the sourcing and management of regulatory datasets.

At SIX, we offer such a solution that is already helping many financial institutions meet their obligations to SFDR reporting and Taxonomy alignment. We have built on our proven record of providing accurate, reliable and time-efficient reference data to gather and manage the many datasets that our clients now need to disclose their ESG metrics.

ESG Data Made Easy

SIX sources and manages data from multiple vendors and sources worldwide. That means our clients get access to a wide array of data sets – covering investee companies, financial instruments and the companies that manufacture financial products. By providing from such a broad pool of information we can minimise data gaps and ensure clients submit the fullest ESG reports to stakeholders.

The over-arching benefit of a setup like this is that it reduces the complexity of regulatory disclosures while maximising the utility of the data.

- **All bases covered:** A key issue for individual data consumers is knowing what data they need. As we've discussed, most firms will need to engage several vendors to ensure they have even minimal coverage to comply with regulatory requirements. Through SIX, clients can directly tap data from a variety of sources, more of whom we are engaging as regulatory disclosure and corporate needs evolve.
- **Agile:** SFDR and EU Taxonomy are not yet fully formed; they will be tweaked and adapted as their various requirements are introduced and even more regulations are set to be added, including a Social Taxonomy and CSRD. That means disclosing companies must ensure they can adapt their disclosure strategies accordingly. SIX supports its clients in sourcing the data they need to meet the latest compliance requirements.
- **We grow with you:** By aggregating data, SIX provides clients with the resources to scale their data operations up or down without the need to add more data feeds at times of growth or retain unwanted and unused services during leaner times. These scenarios can be costly in terms of resources and workforce time, each of which can be better utilised in more productive ways.
- **Quality assured:** As we've discussed, ESG data can vary in its type and quality, posing challenges to financial institutions' data managers who need to combine this information with regular reference data. By entrusting SIX with the task, our customers benefit from a dedicated team of specialists who will clean and standardise content before passing it into clients' systems, ready for immediate use. This includes data obtained from alternative sources, including highly targeted community sentiment scores retrieved from social media by Orenda, a SIX company.
- **Asset discovery:** A defining characteristic of our data sets is that we work directly with hundreds of manufacturers of financial products, such as UCITS funds and pension products. This provides a source of critical data on which investors can gauge what might be a suitable target when making capital allocation decisions.

- Added value: We also aid in the investment discovery process by offering sustainability benchmarks and a suite of ESG indices that give visibility into the sustainability performance of Swiss and Nordic bonds and stocks.

Appendix 1

EU Taxonomy and SFDR Timeline



Appendix 2

Mandatory Principal Adverse Impact indicators

1. GHG emissions

2. Carbon footprint

3. GHG intensity of investee companies

4. Exposure to companies active in the fossil fuel sector

5. Share of non-renewable energy consumption and production

6. Energy consumption intensity per high impact climate sector

7. Activities negatively affecting biodiversity-sensitive areas

8. Emissions to water

9. Hazardous waste ratio

10.

Violations of UN Global Compact principles and Organisation for Economic Cooperation and Development (OECD) Guidelines for Multinational Enterprises

11.

Lack of processes and compliance mechanisms to monitor compliance with UN Global Compact principles and OECD Guidelines for Multinational Enterprises

12.

Unadjusted gender pay gap

13.

Board gender diversity

14.

Exposure to controversial weapons

About SIX

SIX operates and develops infrastructure services for the Swiss and Spanish Stock Exchanges, for Post-Trade Services, Banking Services and Financial Information with the aim of raising efficiency, quality and innovative capacity across the entire value chain of the Swiss and Spanish financial centers. The company is owned by its users (120 banks). With a workforce of 3,685 employees and a presence in 20 countries, it generated operating income of CHF 1.5 billion and Group net profit of CHF 73.5 million in 2021.

For more than 90 years, SIX has provided the financial data and services the industry needs: high-quality data, delivered at the right time, in the right way. From our core reference data on securities, prices, corporate events, tax and regulatory data, to our flagship indices and bespoke benchmarks, SIX offers added-value services that smoothly integrate with your workflows. We free your time and attention to spend on growing your business.

With SIX, you benefit from a unique database of more than 30 million instruments, providing data aggregated directly and in real time from more than 1,800 worldwide sources, already verified, structured, interlinked and enriched. And we do it the right way, with a tireless focus on quality and innovation to serve the wealth and asset management industry as well as global financial institutions. Over the recent years, SIX has developed a renowned expertise on sanctions monitoring at the instrument level.

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