Morningstar's Guide to ESG Reporting

MORNINGSTAR

The Evolution of Investment Reporting

Reporting has always been an integral part of the investment process. Accurate insights into the risk, returns, performance, and costs of investments is what empowers better decision-making from portfolio managers and asset owners to advisers and individual investors.

Recent market shifts, however, have expanded the range of metrics that are now reported on and how these insights are presented. Namely, the transition of sustainable investing from niche to mainstream has influenced investment reporting considerably. Traditional financial and strategic markers are no longer enough; whether to mitigate risk, contribute to positive change, or align their portfolios with their sustainability preferences, more investors now routinely assess the environmental, social, and governance (ESG) credentials of funds and companies and require the data to do so.

Advancing regulations in the ESG space, particularly in Europe, also mean that managers have an obligation to report on the sustainable merits of their products. The likes of the EU Action Plan and its components have placed sustainability considerations at the forefront of all investment decision-making and reporting.

In this guide, we focus on ESG reporting specifically and what has driven its demand. We also look at how firms and advisers can advance their reporting capabilities and empower investor decisions with ESG data and solutions from Morningstar Sustainalytics.

Categorising ESG Reporting

When we talk about 'ESG reporting' as an umbrella term, it covers a range of different types of reporting which can largely be broken down into the following categories:

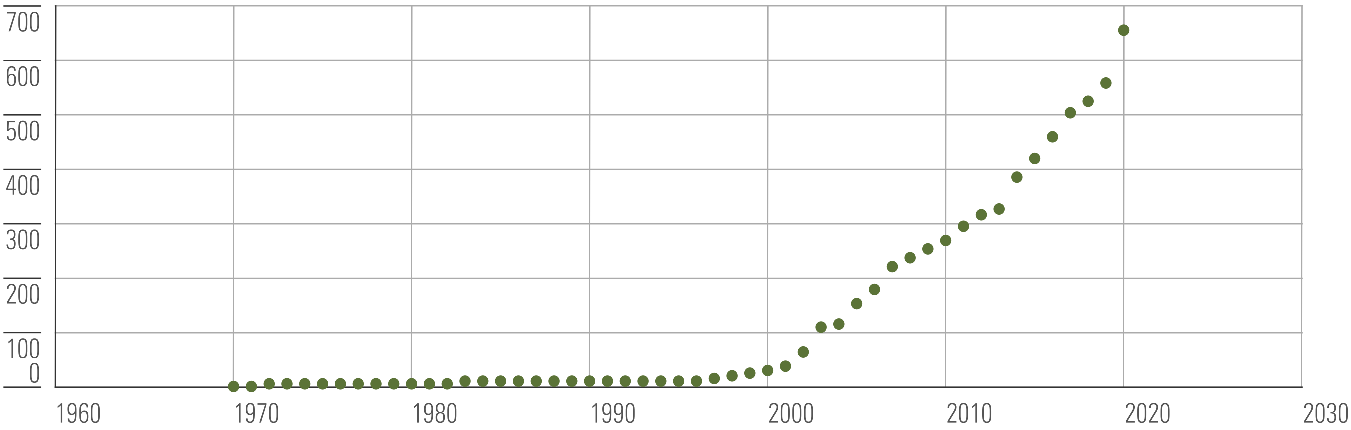
- Regulatory Reporting
- Industry Reporting
- Client Reporting
- Product Factsheets
- Board Reporting
- Internal Analytics

The above list is not exhaustive, and there is often overlap as the data that's collected and used can be applied to a range of use cases. In this guide, we cover regulatory, industry, and client reporting.

Regulatory Reporting

Tightening regulations around ESG issues continue to place further obligations on manufacturers and distributors. The illustration below highlights just how significant ESG policy interventions have been since the early 2000s.

CUMULATIVE NUMBER OF POLICY INTERVENTIONS



Source: PRI responsible investment regulation data

Globally, there are multiple approaches with many similarities on how and what must be disclosed and reported by financial market participants (FMPs). The most advanced body of legislation remains the European Union's Sustainable Finance Action Plan. In order to meet its 2050 carbon-neutrality goal, the EU adopted a 10-point action plan on sustainable finance with an aim to channel capital flows towards sustainable investment while managing financial risks stemming from ESG issues. Several key pieces of legislation place extensive ESG disclosure and reporting obligations on firms, including the EU Taxonomy and Sustainable Finance Disclosures Regulation (SFDR).

EU Taxonomy

The EU Taxonomy is a classification framework to determine whether an economic activity is environmentally sustainable that requires the reporting on eligibility and alignment against six environmental objectives - climate change mitigation, climate change adaptation, sustainable use and protection of water and marine resources, transition to a circular economy, pollution and prevention control, and protection of healthy ecosystems.

Requirements: The EU Taxonomy Regulation introduces mandatory annual disclosure obligations for FMPs and companies covered by the Non-Financial Reporting Directive (NFRD) that require them to disclose their taxonomy-compliant share of turnover, CapEx, and OpEx aligned with the EU Taxonomy.

Reporting Challenges: Firms require granular reporting data on underlying companies' alignment to the EU Taxonomy against technical screening criteria to report on their own portfolios' contribution to the first two environmental objectives, climate change mitigation and adaptation (the remaining four will apply from 2023 subject to the publication of associated delegated acts). To be deemed sustainable, an activity must substantially contribute to at least one of the six environmental objectives, do no significant harm to any of the other objectives, and comply with minimum safeguards created to avoid negatively impacting societal stakeholders. In addition to the specific data required, varying timelines for corporates and asset managers in this case are proving to be a notable reporting challenge.

Sustainable Finance Disclosures Regulation (SFDR)

The SFDR encourages greater transparency from FMPs and financial advisers when it comes to their sustainability-related policies and objectives. By setting strict minimum disclosure standards, the SFDR aims to raise the bar for investment products and prevent greenwashing, particularly for those products promoting environmental or social characteristics and those with sustainability objectives (Article 8 & 9 funds.)

Requirements: Broadly, managers must disclose how sustainability risks are considered in their investment process, what metrics they use to assess ESG factors, and how they consider investment decisions that might result in negative effects on sustainability factors, known as Principal Adverse Impacts (PAIs).

Reporting Challenges: To meet these disclosures, manufacturers require calculations and aggregations at the entity level. This information must be used to create mandatory reporting templates included as annexes to prospectuses and annual reports. Firms also need research frameworks and methodologies that are transparent and comparable between data sets.

MiFID II & Sustainability Preferences

Amendments to the Markets in Financial Directive (MiFID) II and the Insurance Distribution Directive (IDD) mean that as of 2 August 2022, investment firms must consider sustainability risks in all decision-making procedures and when providing financial advice, must obtain sustainability preferences from their clients as part of the suitability process. This must all be documented using relative reporting templates.

Requirements: Depending on the specific client's preferences, advisers will have to source products that have a minimum proportion of sustainable investments as defined by the SFDR or the EU Taxonomy. Clients may also choose only investments that consider PAIs.

Reporting Challenges: Without a standardised approach to calculating the above metrics, managers are implementing a variety of methodologies which makes accurate comparison of products almost impossible. A lack of available data is also making it hard for advisers to fulfil their reporting obligations. Products are on the hook for disclosing their minimum proportion of taxonomy alignment, but the companies in which they are invested will only begin disclosing this information from January 2023. What's more, many funds haven't reported the required information yet or have reported zero exposure to sustainable investments.

Additional Policies

TCFD & the UK's SDR

Recommendations from the Taskforce on Climate-related Financial Disclosures (TCFD) set out a framework of four core elements and 11 recommended disclosures. (See Appendix A.) Various countries are taking steps to mandate or encourage reporting recommendations which include disclosing how organisations identify, assess, and manage climate-related risks and the metrics used to do so.

The UK is the first country in the G20 to mandate TCFD climate-related disclosures across the economy. The FCA has set out a roadmap for broader economy-wide requirements under its Green Finance Strategy and has recently introduced its own principles-based Sustainability Disclosure Requirements (SDR) and investment labels, with a green taxonomy to follow. The requirements will be finalised in due course after the end of the consultation period in early 2023.

Industry Reporting: The European ESG Template

Industry templates have evolved to help meet the growing number of ESG regulatory requirements introduced in Europe.

Notably, the **European ESG Template (EET)** is a new tool designed to enable the efficient exchange of ESG data between product manufacturers and distributors to fulfil requirements under the SFDR, EU Taxonomy, and the relevant delegated acts complementing MiFiD II and the IDD. Asset managers marketing their funds in the European Union started to submit EET data voluntarily from 1 June.

The template contains approximately 580 fields, although these are not all mandatory, and contains sections for reporting on taxonomy alignment, sustainable investment percentage, PAIs, exclusions, stewardship codes and eco-labels.

How has the industry responded?

In January 2023, Morningstar collected EET data on 96,082 share classes, accounting for 67% of all share classes in scope of MiFID II, representing 18,581 funds to see how the market has responded to the EET in the early stages of its application. We looked at the coverage and values of PAI consideration, sustainable investment exposure, and taxonomy alignment, including 8,130 Article 8 funds and 9,106 Article 9 funds.

Here's what we have found:

- All Article 8 and Article 9 products are requested to disclose whether they consider PAI indicators, explaining the high percentage of 99% of surveyed funds that populated the PAI consideration field.
- Over 59% of the surveyed Article 8 and Article 9 funds reported a minimum percentage of sustainable investments, and 41% disclosed a minimum percentage of taxonomy-aligned investments. (This represents an increase from 3 months ago thanks to the additional requirement of adding detailed SFDR annexes to product disclosures that took effect in January 2023.)
- Less than a third (31.6%) of Article 8 funds report targeting zero exposure to sustainable investments, and 37.5% report an allocation of 0-10% exposure.
- 63% of Article 9 funds plan to have more than 70% exposure to sustainable investments and just 6.3% target sustainable investment exposure between 90% and 100%. Only 36 Article 9 funds aim for a 100% allocation to sustainable investment.

In addition to the well-known conundrum of issuer data availability to populate the EET, a lack of consensus over the SFDR's definition of a sustainable investment has resulted in inaccurate and incomparable reporting. Products with similar mandates and portfolios are reporting divergent exposures to sustainable investments depending on the methodology chosen by their providers. The EET is still in its early days, but sentiment from the market suggests there is a lot of work to do to achieve a straightforward, standardised approach to the sharing of ESG data.

(You find out more about the EET and Morningstar's analyse in our SFDR Article 8 & 9 Q4 Report.)

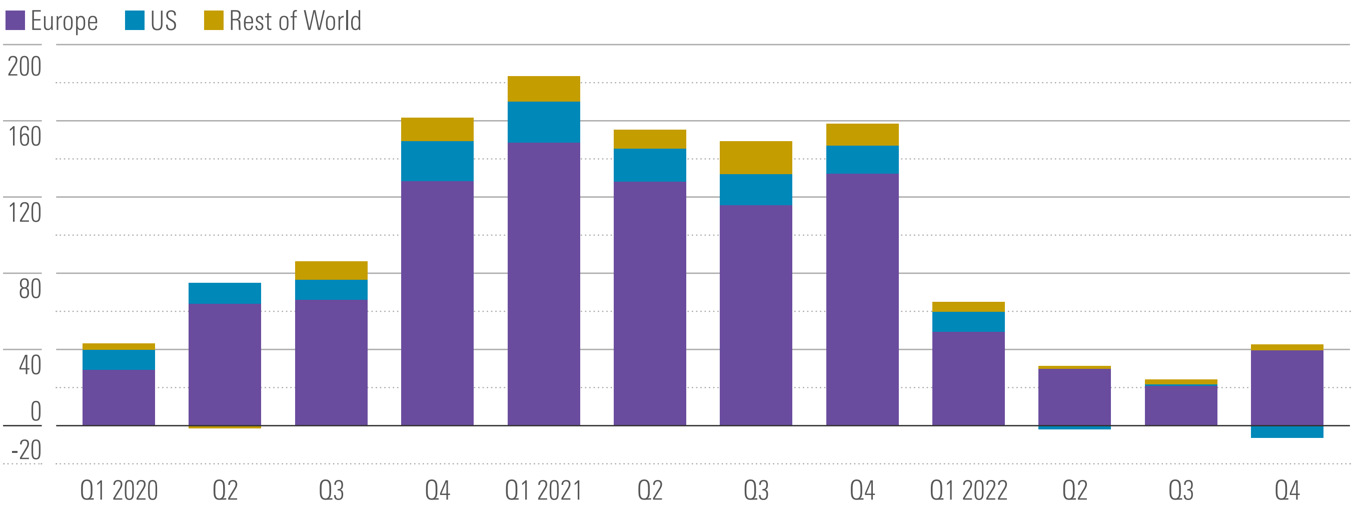
Client Reporting: ESG for Client Portfolios

ESG has become more important both for advised and non-advised investors. For advised clients, as mentioned previously, under the amended MiFID II regulation sustainability preferences have become part of the suitability process. This means SFDR, taxonomy alignment and/or PAIs will be used in the assessment and therefore are required in the subsequent client reporting. Best practice, however, will require going beyond the EU's definition of sustainable preferences to help combat concerns around greenwashing - investors need reliable and accurate data that supports their specific sustainability requirements, not just those that fit the EU's framework.

Thankfully, these policy changes and concerns align well with increasing client demand for sustainable investing. Whether it's a growing concern about climate change or a stronger societal conscious born out of the Covid-19 pandemic, people have become more conscious about the impacts of ESG risks on their investments and the impact of their investments on the planet.

Growing interest is echoed in fund flows. According to asset flows data from Morningstar—despite inflationary pressures, rising interest rates, lingering recession fears, and the conflict in Ukraine—the global universe of sustainable funds still attracted USD 37 billion of net new money in the fourth quarter of 2022, once again proving resilient relative to the broader market.

QUARTERLY GLOBAL SUSTAINABLE FUND FLOWS (USD BILLION)



Source: Morningstar Direct, Manager Research. Data as of December 2022

- How is the investment sustainable?
- How do I know this investment isn't greenwashing?
- How can I dig into what's happening from an E, S, or G perspective?
- I want to understand the fund's ESG objective.
- I want easy to understand information.
- I want key indicators so I can easily compare investments.

The Reporting Challenge: Understanding What Investors Care About

To tell a powerful sustainability story, firms will be challenged by how they distil complex ESG data to their investors across each consumer segment. Moreover, one investor's ESG goals and objectives will differ entirely to another's and trying to meet all of these ambitions highlights the need for diversification of products and how they are communicated.

Research from across the industry points to the same conclusions:

1. Investors worry about greenwashing; and
2. They want a common, coherent way of understanding and implementing ESG data.

Boring Money's Sustainable Investing Report 2022[1] confirmed that the top concern among seven different ESG investing personas – from 'Eco Warriors' at one end of the spectrum to those purely focused on returns on the other – is greenwashing. This is also echoed by a recent survey conducted by the Luxembourg regulator,[2] where two-thirds of respondents voiced the same concern.

There is no shortage of examples to compound investors' fears of greenwashing. In fact, after reviewing sustainable funds recommendations in 2022, Morningstar culled 27% of funds from its

1. boringmoneybusiness.co.uk/sustainable-investing-report-2022/
2. investmentofficer.lu/en/news/european-investors-most-concerned-over-greenwashing

European sustainable funds' list, which did not meet the sustainable criteria, finding that asset managers were marketing products as promoting ESG characteristics without making any material changes to their portfolio or investment strategies.

Other investor concerns that consistently appear across multiple sources are a lack of standardisation and a lack of confidence. According to JP Morgan's 2022 Future Focus Survey,[3] almost half (45%) of the European investment advisers surveyed stated that investors are unsure about where to source the best information, and the same number of investors are confused about which metrics to factor into investment decisions.

To combat claims of greenwashing and give investors the transparency they need to make investment decisions that align with their sustainability preferences, research concludes that independent, industry wide ESG metrics are essential.

Your Client Reporting Checklist

Below are the summary findings of research conducted by Morningstar and Boring Money, a recent FCA paper on improving consumer comprehension of financial sustainability disclosures,[4] and best practice that we are seeing today in the industry, to help you better understand what investors are asking for in terms of how sustainability data is communicated and presented.

Signposting

ESG is complex and can be overwhelming even for those who have conducted some prior sustainability research, let alone those that have not. Guidance and signposting are essential, especially when it comes to factsheets, to give investors a clear picture of what an investment is trying to do and how it is meeting its ESG objective. Setting out a clear fund/portfolio strategy alongside relevant data that communicates how that strategy is met proves to be a winning formula.

Explanations

It should not be assumed that investors have a certain level of understanding, even for those investors who place a greater focus on sustainability issues. Concise, jargon-free and relevant explanations can help to avoid misinterpretations and confusion when referring to different metrics. Equally, when trying to distill a lot of information on to one page, it pays to really think about what to include and its relevance. Documents that are crammed with information prove unpopular, as do those lacking in sufficient explainer content.

Visuals

Visually engaging documents with use of colour and images are more likely to encourage a detailed review, with the additional benefit of being able to scan and identify key information easily when necessary. (This is particularly useful when considering exclusions, for example.) Consistent colour coding, sizing, and spacing of information are all design touches that can aid interpretation of data.

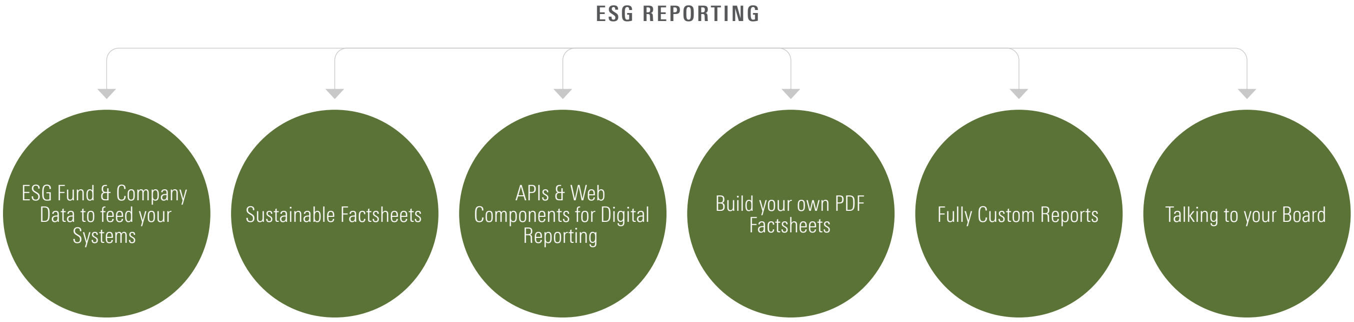
Context

Colourful graphics and explainer text can still mean very little without the right context – clarity cannot be sacrificed for exciting layouts and design. Giving a fund a carbon risk score of 7, for example, does not say much unless it is put into context. Providing comparisons using familiar metrics, peers or benchmarks helps to improve the relevancy and impact of the data giving investors a clear understanding of what it means.

3. am.jpmorgan.com/content/dam/jpm-am-aem/emea/regional/en/pdfs/future-focus-survey-report-final.pdf
4. fca.org.uk/publication/occasional-papers/occasional-paper-62.pdf

Morningstar Can Help You Meet Your ESG Reporting Needs

ESG reporting is multi-faceted and is likely to evolve further as the sustainable investing universe continues its impressive momentum. Juggling regulatory obligations with creating a compelling ESG story and the needs of end clients requires a lot from firms.



Morningstar has a comprehensive offering to help professional investors and managers successfully consolidate ESG data into the investment process. This has been accelerated by the 2020 acquisition of Sustainalytics, the largest independent provider of ESG research and ratings. Together, Morningstar and Sustainalytics are leading the global sustainable investing landscape with ESG coverage on more than 85,000 funds, 16,300 companies, and 172 countries.

Morningstar's reporting capabilities help firms to manage their regulatory requirements while amplifying their message by delivering custom ESG proposals and reports to clients. The following suite of solutions can be tailored to meet the needs of your firm:

ESG Regulatory Reporting Solutions

EU Action Plan and MiFID II:

- End-to-end solutions from across Morningstar Sustainalytics - from raw data and transparent methodology to portfolio and reporting solutions - so investors have a clear path to compliance.
- An EU Taxonomy solution that lets investors incorporate EU Taxonomy criteria into their investment decisions. The EU Taxonomy data set includes both estimate and reported data at the company level and aggregated to the fund level.
- A set of ESG research solutions to identify and manage both ESG risks and potential PAIs to fully comply with the SFDR requirements.
- The industry standard European ESG Template (EET) designed to enable the efficient exchange of ESG data between product manufacturers and distributors to fulfil regulatory requirements under the EU Action Plan.
- Portfolio Analysis X-Ray API solution for on-the-fly calculation for use during the advice process and for mapping up to client accounts for overview.
- Portfolio Analytics Services provides a complete calculation of ESG and Regulatory metrics for custom portfolios, which can be entity, products (discretionary mandates) and client portfolios, delivered to clients via a data feed.

TCFD Reporting Requirements:

- Morningstar Sustainalytics proprietary research, ratings, and data to fulfil TCFD reporting requirements including Carbon Risk Ratings, Low Carbon Transition Ratings, Carbon Solutions, Fossil Fuel Involvement, Physical Climate Risk Metrics, & more.

ESG Client Reporting Solutions

Communicating with your clients requires more than just a one-size-fits-all approach. We've built our ESG reporting solutions on Morningstar's foundational sustainable investing framework, which outlines the various paths investors can take to act on their sustainability objectives. Our reports are tailored to the nuanced motivations that make investing so personal.

MORNINGSTAR'S SUSTAINABLE INVESTING FRAMEWORK AND WHAT WE OFFER FOR EACH THEME

APPLY EXCLUSIONS

Investors who apply exclusions remove issuers from their portfolios based on certain products or services, an industry, or corporate behaviors, like major controversies.

- Product Involvement Themes
- Controversies
- Country Risk Ratings
- Morningstar Managed Portfolios

LIMIT ESG RISK

Investors who limit ESG risk use ratings to understand a company's exposure to certain material ESG issues.

- Sustainability Ratings
- ESG Risk Ratings
- Global Sustainability Index
- Morningstar Managed Portfolios
- Pooled Employer Plans

SEEK ESG OPPORTUNITIES

Investors who use ESG information to seek opportunities apply data to identify companies that are sustainability leaders.

- Low Carbon Designation
- Carbon Risk Rating
- Morningstar Managed Portfolios

PRACTICE ACTIVE OWNERSHIP

Investors who practice active ownership engage with companies to influence sustainability-related policy.

- Proxy Votes Data
- ESG Commitment Level

TARGET THEMES

Investors who target sustainability themes identify investments that stand to benefit from secular trends toward greater sustainability in the way we live and work.

- Impact Metrics
- Sustainable Attributes
- DEI Data
- PitchBook Climate Tech Map
- Women's Empowerment Index

ASSESS IMPACT

Investors who use security selection to make an impact on sustainability goals integrate impact assessments into portfolio construction.

- Second-party Opinion Services
- Impact metrics

Customisable Factsheets, Templates, and Reports

The following solutions help to meet client reporting checklists that have emerged from industry research mentioned above. Our templates and analytics deliver on signposting, explanations, visuals, and content.

Presentation Studio

- Transform and customise your firm's ESG investment stories into professional, compliance-approved, branded reports.
- Drag-and-drop report components from a library of professionally designed visuals to communicate both your proprietary data and Morningstar insights in an accessible way.

Report Portal

- Create efficient workflows producing the Presentation Studio templates that are housed in Morningstar Direct.

- On-demand integration optimises your sales team by immediately distributing collateral to client-facing groups, so the whole team can access custom templates that have been preapproved by your compliance team.

Morningstar Publishing System

- End-to-end document management service to centralise and securely deliver quality factsheets, regulatory documents, and marketing communications.
- Outsource report production completely or integrate Morningstar Publishing System into your current report generation process for greater efficiency.

Morningstar Essentials

- Enhance marketing materials with Morningstar industry-standard statistics recognised by investors and advisers worldwide.
- Comprehensive portfolio-level ESG and carbon metrics let you:
  - Shine a light on product transparency with more than 100 ESG datapoints, including our Sustainability Rating and Low Carbon Designation
  - Keep clients informed with Sustainability reports that highlight key product holdings and their contribution to ESG scores.
  - Put performance and sustainability side by side to tell the big-picture story.
- The Morningstar Sustainability Rating™, Low Carbon Designation, Morningstar Rating™, and Morningstar Category can be used in advertisements, websites, and other materials to communicate the advantages of your funds.

Ready to learn more?

- [Start a free trial of Morningstar Direct]
  Morningstar's flagship investment and research platform, Morningstar Direct, enables the most comprehensive ESG data set in the industry to be incorporated into research, investment analysis, portfolio construction, strategy analytics and reporting, to create and market quality ESG portfolios and products that align with investor values.

- [Morningstar ESG Reporting Solutions]

Appendix A.

Governance	Disclose the organization's governance around climate-related risks and opportunities.	Describe the board's oversight of climate-related risks and opportunities. Describe management's role in assessing and managing climate-related risks and opportunities.
Strategy	Disclose the actual and potential impacts of climate-related risks and opportunities on the organization's businesses, strategy, and financial planning where such information is material.	Describe the climate-related risks and opportunities the organization has identified over the short, medium, and long term. Describe the impact of climate-related risks and opportunities on the organization's businesses, strategy, and financial planning. Describe the resilience of the organization's strategy, taking into consideration different climate-related scenarios, including a 2°C or lower scenario.
Risk Management	Disclose how the organization identifies, assesses, and manages climate-related risks.	Describe the organization's processes for identifying and assessing climate-related risks. Describe the organization's processes for managing climate-related risks. Describe how processes for identifying, assessing, and managing climate-related risks are integrated into the organization's overall risk management.
Metrics and Targets	Disclose the metrics and targets used to assess and manage relevant climate-related risks and opportunities where such information is material.	Disclose the metrics used by the organization to assess climate-related risks and opportunities in line with its strategy and risk management process. Disclose Scope 1, Scope 2 and, if appropriate, Scope 3 greenhouse gas (GHG) emissions and the related risks. Describe the targets used by the organization to manage climate-related risks and opportunities and performance against targets.