SUPERVISION REPORT

AFM explorative study on ESG data risk management by asset managers

In short Asset managers frequently use ESG data. To prevent incorrect disclosures and erroneous decisions with regard to business objectives and risk exposure, it is important that they provide safeguards regarding the reliability and independence of this data. Based on an explorative study, the Dutch Authority for the Financial Markets (AFM) has gained insight into the way ESG data is dealt with and how the verification of the accuracy and completeness of the data is carried out. In this report, the AFM shares a number of observations that can support asset managers in establishing processes, systems and internal controls for risk management regarding the use of ESG data.

OKTOBER 2024

AFM

1. Introduction

Asset managers frequently use ESG data. They indicate that the availability, reliability and comparability of ESG data is a challenge. How do asset managers deal with this and how do they ensure that the data used is correct and complete? The AFM conducted an explorative study. This report contains the most important observations, which can support asset managers in establishing processes, systems and internal controls for risk management with respect to the use of ESG data.

Supervising compliance with rules for controlled and sound business operations

The AFM supervises compliance with the rules for controlled and sound business operations that apply to investment firms and investment managers of both AIFs and UCITS (hereinafter: asset managers).[1] This also includes the supervision of compliance with European legislation.

As a result of the amendments to the UCITS Implementing Directive and AIFMD Delegated Regulation,[2] investment managers should ensure that sustainability risks are integrated into their risk management processes and are taken into account in their investment policies. Requirements have also been set for investment firms with regard to the integration of sustainability risks. These requirements are laid down in the MIFID II Delegated Regulation[3].

To meet these requirements, asset managers need Environmental, Social and Governance (ESG) data for, among other things, the identification and management of relevant sustainability risks, the measurement of the adverse impacts of investment decisions and the determination of criteria around the 'do no significant harm' principle.[4]

Availability, reliability and comparability of ESG data is a challenge

Asset managers can obtain the necessary data directly from the issuer, apply or develop their own methods to calculate ESG data themselves, or purchase the data from third-party data providers. Regardless of the chosen source or method, asset managers indicate that the availability, reliability and comparability of ESG data is a challenge. As a result, the data needs of asset managers cannot be fully met, at least not in the short term.

The observations will support asset managers in establishing processes, systems and internal controls for risk management

Ensuring the reliability and independence of ESG data is an important precondition for the adequate management and integration of sustainability risks in business operations and investment policies. The AFM therefore conducted an explorative study into the management of risks regarding the use of ESG data among six asset managers[5]. In addition, the AFM received additional information from four other asset managers and the industry associations DUFAS and VV&A during a roundtable discussion on this subject. As a result, the AFM has gained insight into the way ESG data is dealt with and how the verification of the accuracy and completeness of the data is carried out. The AFM shares its observations with the market, because they could support asset managers in establishing processes, systems and internal controls for ESG data risk management.

1 The way in which investment managers of AIFs and UCITS as well as investment firms implement the provisions of Section 4:14 of the Financial Supervision Act (Wft) that apply to them with regard to controlled and sound business operations is an essential part of supervision.

2 Directive 2010/43/EU (UCITS Implementing Directive) and Delegated Regulation (EU) No 231/2013 (AIFMD Delegated Regulation).

3 Delegated Regulation (EU) 2017/565 (MIFID II Delegated Regulation).

4 See Article 2(17) of the Regulation on sustainability-related disclosures in the financial services sector (SFDR) EU (2019/2088) which uses the 'do no significant harm' principle in the definition of sustainable investment.

5 Refer to Study design in Appendix I.

Key observations

Based on the explorative study that was conducted, the AFM has four observations on specific themes in the field of (ESG) data risk management.

1. Asset managers have established the governance structure with regard to the management of ESG data risks in different ways.
2. Many asset managers use one or more third-party data providers for the majority of their ESG data needs.
3. Using an unambiguous definition of data risk supports asset managers in identifying and managing this risk.
4. Asset managers have both proactive and reactive policies and control processes to ensure the quality of ESG data.

The observations are described in further detail in the next chapter. The chapter thereafter outlines the challenges asset managers face in collecting and processing ESG data.

2. Observations

This chapter presents the most important observations that can support asset managers when establishing efficient risk management practices regarding the use of ESG data.

Observation 1. Different set-up of data governance structure

Asset managers have set up the governance structure around (ESG) data and (ESG) data risks in different ways.

Of the ten asset managers that participated in one or more phases of the explorative study, four asset managers have implemented a data management structure.

- They formalised the responsibilities for the use and control of data within the governance structure by assigning the roles of *data owner* and *data steward*.
- Some asset managers differentiate between ESG data and non-ESG data, while others apply the same structure for all types of data.
- One of these asset managers has drawn up a separate data risk management policy and has set up a data governance committee.

At the time of the explorative study, six asset managers had not (yet) specifically organised or recorded the responsibilities with regard to (ESG) data. From this group, two asset managers refer to their Three Lines structure in general, and two asset managers indicate that they are in the process of assessing whether or not they want to set up a specific structure for (ESG) data.

Asset managers establish the governance structure around (ESG) data as they see fit, either through a specific data management structure or embedded in their generic Three Lines structure. The AFM expects asset managers to incorporate their responsibilities with regard to (ESG) data and (ESG) data risks into the governance structure in an effective and appropriate manner.

Observation 2. ESG data mainly via third-party providers

Many asset managers use one or more third-party data providers for the majority of their ESG data needs.

The explorative study showed that asset managers frequently use third-party providers to obtain ESG data. Larger asset managers often use multiple third-party providers to meet their ESG data needs. This is done, among other things, because of the specialist data needs per investment theme (whereby third-party providers do not cover the entire spectrum with their data offerings) and to be able to compare data, in order to achieve a minimum margin of error in the datasets. For smaller asset managers, this is often too expensive.

The AFM also noticed that, to a greater or lesser extent, asset managers collect or compile data themselves, for example by requesting it directly from the issuer or by calculating it themselves based on their own methods. This 'proprietary data' ranges from 10% to 100% of the total ESG data used by the asset managers in question.

Considerations regarding the choice for third-party providers
Key reasons why asset managers purchase ESG data from third-party providers include:

- Third-party providers collect ESG data from issuers and countries on a large scale, making it more cost-efficient for some asset managers to purchase this data instead of composing it in-house.
- Third-party providers have specialised knowledge and expertise on complex ESG topics, such as climate risk modelling.
- Third-party providers have access to ESG data that is difficult or impossible to obtain in other ways, such as analyses of satellite images.

Considerations regarding the choice for in-house composition
In a number of cases, asset managers consciously choose to compose ESG data and/or ESG data products in-house. The main reasons for this are:

- High-quality, appropriate, or in some cases reasonably priced data is not always available through third-party data providers. This is especially true for data on private markets, low-income countries and smaller businesses.
- In-house data is more in line with the organisation's own risk model for identifying and weighing ESG risks.
- In-house data may also be better aligned with the methods for translating ESG data into an ESG outcome for a particular activity, investment or portfolio if those methods have been developed by the asset manager itself.

Asset managers have their own, valid reasons for choosing to purchase from third-party providers or to compose in-house ESG data needed for their business processes and risk management. Whichever version asset managers decide on, the AFM expects them to set up adequate controls on the ESG data flows in order to guarantee the accuracy and completeness of the data.

Observation 3. Definition of data risk supports risk identification and risk management

Using an unambiguous definition of data risk helps asset managers identify and manage this risk.

Definition of data risk
The explorative study showed that four asset managers use a fixed definition of data (management) risk in the organisation. In the case of three asset managers, the specification of the various identified data risks was subsequently also captured in internal documentation (such as the risk management framework and risk appetite statement). One asset manager also indicated that, while the size of the organisation does not necessitate the implementation of such a definition, in practice, it does prove to be useful.

Risk identification
Using their own definition of data risk as a starting point, the asset managers involved have identified various risks with regard to the use of (ESG) data. The identified risks vary in nature from operational risk to data quality risk to continuity risk. An overview of these risks can be found in Appendix 2.

Risk management process
The explorative study showed that two asset managers have set up processes and controls specifically for ESG data, in order to assess and manage the identified risks regarding the use of this data. The other organisations have not set up a specific process for ESG data to mitigate the identified risks. These risks are instead factored into the generic risk management activities and control processes. This can be explained by the fact that not every asset manager distinguishes between ESG data and other data.

Since risks with regard to the use of (ESG) data can be defined in many ways and at all levels, it is recommended that the same language is applied within an organisation about what this means and encompasses. An unambiguous definition of data risk helps to achieve this.

Asset managers set up the control processes around (ESG) data risks as they see fit, either through a separate structure or embedded in the existing risk management framework. Whichever variant an asset manager chooses, the AFM expects (ESG) data risks to be on the radar of the organisation and that these risks are effectively managed.

Observation 4. Both proactive and reactive policies and control processes support data quality

All asset managers have both proactive and reactive policies and control processes in place to ensure the quality of ESG data.

Proactive data quality policy and control process

All organisations participating in the explorative study have or are developing a so-called *proactive* policy and process to guarantee the quality of data. This policy includes, among other things, the following:

- Through data contracts, agreements about the quality of data are recorded between data owner and data user, including on accuracy, timeliness and completeness.
- The time limits for data retention and those responsible for it are laid down.
- A distinction is often made between critical data, which is material for a business process, and non-critical data, needed to determine the appropriate types and degrees of control.
- Structural control processes have been set up with regard to the accuracy and completeness of (ESG) data.
- Some asset managers have indicated that in some cases they also carry out ad hoc checks on the data quality, for example in the case of notable outliers and potential new investments.
- One asset manager tries to improve the data quality by contributing to industry initiatives for standardisation.

Reactive data quality policy and control process

The explorative study showed that all asset managers also have a so-called *reactive* data quality policy that has been implemented into an embedded control process. This applies when irregularities are found between the (purchased) data from different third-party providers, between the output of different (ESG) data sources, or between internal data calculations and the data from third-party providers. These irregularities come to light, among other things, during the structural quality checks carried out by the asset managers or when data users report problems with the data.

Feedback loop to third-party providers

If asset managers identify irregularities in the (ESG) data belonging to a dataset from a third-party provider, all asset managers will contact the provider in question. They require the provider to record the incident and carry out the necessary investigations, and to be notified of the corrective actions as soon as possible. One of the actions taken by an asset manager is to overwrite the relevant data points in the dataset themselves after receiving feedback from the third-party provider.

Data enrichment

The explorative study showed that asset managers generally only use backward-looking ESG data, including in making estimates when there are no data points available on a specific issuer. Only one asset manager - for listed investments - takes future estimates into account to enrich the in-house data, for example by doing analyses of future macro and micro trends.

The asset managers that participated in the various phases of the explorative study all have both proactive and reactive policies in place, and have set up the associated control processes, to check the quality of the (ESG) data they need. This is done to check the accuracy and completeness of the (ESG) data prior to the internal processing of the data and to rectify irregularities when using the data. It is important that asset managers remain critical towards the quality of (ESG) data and, where possible, carry out their own controls to ensure the accuracy of the data.

3. Challenges

The explorative study also revealed a number of challenges regarding the collection and use of ESG data.

Methodologies
There is a lack of transparency on the methodologies of third-party providers. This makes it difficult to compare data from one provider with data from another provider. In addition, there is often no consensus on the methods for arriving at ESG indicators. This is due to the large (and fast-growing) number of ESG data providers, the different ways of collecting data, and the fact that third-party providers use different definitions of the same data points. These challenges are difficult for asset managers to address.

Uniformity
Another challenge is the lack of uniformity in the provision of data by ESG data providers or by issuers in which investments are made. This increases the risk of data errors. A number of asset managers are trying to mitigate this risk by requiring ESG data to be provided in prescribed formats.

Data timeliness
Asset managers also face the fact that the timeliness of data is not always guaranteed, because issuers usually report only once a year. One of the actions taken by an asset manager to address this is to apply so-called freeze periods. This means that the data that is used is fixed as of a certain date and is not changed after that. In this way, it is ensured that further processing is based on the same data set(s), even if there are later data reports available.

Link with the right issuer
Finally, it appears to be difficult sometimes to link data to the right issuer due to complex legal structures and very similar names. As a possible solution for this, participating asset managers suggest the use of LEI codes, because ISINs would not always be available.

4. Next steps

The AFM expects asset managers to pay continuous attention to the requirements for controlled and sound business operations. This also includes the adequate management and integration of sustainability risks into the business operations and investment policy. An important precondition is the establishment of safeguards with regard to the reliability and independence of ESG data. The observations from this explorative study can further support asset managers in establishing processes, systems and internal controls for ESG data risk management.

In the upcoming period, the AFM will continue to focus on the various aspects of risk management by asset managers, including the risk management practices around the use of data in general.

Appendix 1: Design of the explorative study

The previous chapters contain the observations that can further support asset managers in establishing processes, systems and internal controls for ESG data risk management. These are based on an explorative study the AFM conducted among six asset managers, and the additional insights that the AFM obtained from four additional asset managers during a roundtable discussion on this subject. This appendix describes the study design.

The explorative study was carried out in three phases and took place in the second half of 2023 and the first half of 2024.

In phase 1, the AFM sent a questionnaire to six participating asset managers. The questionnaire included questions about ESG data and/or ESG data products obtained through the services of one or more third-party providers (referred to as third-party ESG data), and questions about ESG data obtained directly from the issuer or calculated by investment managers and investment firms themselves (referred to as in-house ESG data). These questions focused on four specific themes regarding (ESG) data management:

1. Data governance
2. Data design and use
3. Risk management
4. Data quality

The six asset managers to which the information request was sent were selected on the basis of 'assets under management' (AuM) and 'dominant investment strategy', among other things, in order to arrive at a selection that is representative of the entire asset management sector. These asset managers use ESG data for a variety of purposes, ranging from the selection and monitoring of investments, reports to clients and stakeholders (including supervisory authorities) to risk management practices.

In phase 2, in-depth interviews were held with four of the six participating asset managers. These asset managers were randomly selected. The aim of the interviews was to obtain further information on how these asset managers have set up risk management processes with respect to ESG data, and which choices they made in this regard. In order to further understand the market of ESG data, the AFM also held informative discussions with two providers of ESG data at the start of the explorative study.

On the basis of the information obtained from phase 1 and phase 2, the AFM arrived at a number of observations. These observations formed the basis for phase 3.

In phase 3, a roundtable discussion took place. The aim of the roundtable discussion was to further explore the observations from phase 1 and phase 2 and to gauge the broader ideas in the market. The group of attendees therefore consisted not only of asset managers who participated in the explorative study in phase 1 and/or 2, but also of four asset managers that had not previously been involved in the explorative study, and the industry associations DUFAS and VV&A.

Appendix 2: Identified (ESG) data risks with description

This appendix contains an overview of the risks associated with the use of (ESG) data that have been identified by the participating asset managers. These risks do not have to be (to the same extent) relevant to each asset manager. Moreover, it is not an exhaustive list. Asset managers can also identify other risks.

Risk	Description
Operational risk	• *Incomplete or incorrect administration of investments and transactions* • *Improper follow-up of investments due to incorrect processing and analysis of information*
IT-security and business continuity risk	• *Availability of information systems not guaranteed* • *File integrity and reliability not guaranteed*
Data quality risk	• *Timeliness, completeness, correctness, availability of the data not in order.* • *Consequences: incorrect representation of the facts (greenwashing) and erroneous investment decisions*
Data management risk	• *Poor management of data within the organisation* • *Consequence: operational use of incorrect information*
Third-party risk	• *Problems regarding the services provided by third parties* • *Example: vendor lock-in*
Processing risk	• *Incorrect input or data* • *Manipulation of data* • *Loss of data*
Model risk	• *Adverse impact on decisions due to incorrect or incorrectly used models* • *Examples: back-end coding is incorrect or incorrectly edited, unauthorised changes have been made to the model*
Continuity risk	• *Lack of expertise within the organisation* • *Lack of mechanisms to keep knowledge updated*