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How to ensure regulatory compliance for the integration of sustainability risks and detecting new opportunities

A contribution by our Sponsor Universal Investment

ESG regulation is growing in complexity. For investors, identifying potential ESG issues related to their investments and classifying them in a comparable manner across asset classes and investment vehicles is becoming crucial. Moving on from current approaches to ESG reporting, real-time analysis is one way to integrate sustainability risks and identify opportunities in order to make impactful investments.

According to ECB data, private and institutional investors a aain the European Union and England have invested a total of 13.6 trillion euros in investment funds. Germany is the largest market for UCITS and AIFs, with assets of 3.2 trillion euros. This corresponds to a share of 23 percent of the European market.

Against the backdrop of increasing regulation in the ESG sector, it is becoming more and more important for institutional investors to maintain a precise overview of their investments. However, conflicting ESG ratings and a host of different approaches to scoring a company or an investment on environmental, social and governance criteria make it difficult for investors to compare results. On top of this, institutional investors, such as pension funds, also need to be able to provide documentary evidence that their investment approach and implementation are in accordance with their statutes and their stakeholder's wishes.

This is where Universal-Investment steps in as a fund service platform and Super Management Company. Universal-Investment's ESG reporting allows for comparisons to be made, for example across different fund vehicles. As a full-service partner, Universal-Investment offers institutional investors and asset managers efficient administration as well as solutions for structuring their funds, securities and alternative investments, complemented by state-of-the-art risk management. A capital management company that purely specialises in the administration of special assets, the so-called Master-KVG is independent and can connect specialised asset managers and advisors. The Master-KVG is able to implement sustainability criteria in all asset classes, from securities to alternatives to real estate. Universal-Investment acts as a responsible trustee and since innovation has always been part of the company's DNA, Universal-Investment takes the lead on issues that affect its clients, such as the integration of sustainability risks.

Sustainability risks – the framework

"Sustainability risk" is defined as an environmental, social or governance event or condition that if it occurs could have a negative material impact on the value of an investment. Sustainability risks are not defined as a new risk category, rather as a factor of existing risk types, like credit risk, market (price) risk, operational risk, strategic risk or reputational risk. This is due to the nature of sustainability which impacts have already been taken into account in the past by implicitly considering material risk factors when assessing a potential investment. Sustainability risks can be divided into physical risks and transition risks. Physical risks arise, for instance, as a result of climate change and environmental conditions like heatwaves, storms or other extreme weather events that may directly affect companies' operations. Transition risks may arise as a result of the transition to a low-carbon economy when, for example, emission certificates that may be crucial for a company's operations become more expensive due to scarcity. If these sustainability risks materialise, they have a significant effect on existing risk types. For example, if a pension fund is invested in companies whose operations might be affected by regulatory changes, these investments might become so-called stranded assets that suffer unexpected declines in value.

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Accounting for sustainability risks in investment decisions

Integrating sustainability risks into investment decisions is of growing importance to investors as the European Union's Sustainable Finance Disclosure Regulation (SFDR) obliges all European funds to disclose whether and how sustainability risks are taken into account in investment decision-making processes. For Germany, the Federal Financial Supervisory Authority (German: Bundesanstalt für Finanzdienstleistungsaufsicht (BaFin)) has published the "Guidance Notice on Dealing with Sustainability Risks", underlining that consideration of sustainability risks should be integral to previously mentioned risk types.

Revisions to other European regulations, such as UCITS and AIFMD, make it necessary to integrate sustainability risks into governance structures of financial market participants. However, so far, no reliable standards for this integration have been established, leaving market participants facing severe problems putting this regulation into action.

News-based ESG Scores as one way to tackle sustainability risks but also identify potential opportunities

As European and national regulators push for greater transparency and accountability in the integration of sustainability risks, market participants are looking for possible ways to integrate sustainability risks into already existing risk models, stress tests and scenario analysis. To be able to react fast when sustainability risks materialise, an in-depth analysis and assessment of environmental, social or governance factors needs to be accessible.

With this in mind, the Innovation Management and ESG-Office of Universal-Investment, together with Berlin-based start-up YUKKA Lab, have developed an approach that makes sustainability risks more measurable and comparable. Events in the news around a company are being scanned using a cutting-edge natural language processing technology that tracks public mood about that company or a particular topic. This analysis is then used to calculate an overall news-based ESG Score. This Score gives a real-time indication of the company's media presence related to relevant positive or negative ESG events, which can be translated into potential risks as well as opportunities. The ability to drill down on specific news articles, makes the score easy to understand and shows the news behind it.

The tool detects expected and unexpected events, and their participants, in the news in real time, starting from an event cluster which is being used to identify areas of potential risk and opportunities in the three sustainability fields: Environment, Social and Governance. The analysis of the semantic structure of a sentence, identifies participants in the event, learns new linguistic expressions and is paired with ontology in order to understand related entities. The engine uses Natural Language Processing (NLP), a subfield of artificial intelligence which aims to understand human language and extract and interpret information.The sentiment analysis identifies emotional statements and classifies terms on a semantic approach as positive, negative or neutral.

Transforming unstructured data into actionable scores

Once the individual events are identified and classified, they can be fed into an ESG risk-scoring model that converts unstructured real-time news data into actionable scores by applying weighting and persistence for each event. Such scoring models can be iteratively evaluated and gradually improved to fine-tune its calibration and increase its accuracy, either based on statistical approaches or, if suitable, on neural networks.

This approach can be used as a building block for assessing sustainability risks. It offers the advantage that it is faster than the services of established ESG data providers because the sentiment analysis is based on real-time data, while traditional ESG reporting tends to use past data and only takes current developments into account with a delay. From an investor's point of view, time is essential to ensure that their investments are compliant with their own statutes as well as with an increasingly complex regulatory landscape.

Next to the risk perspective the tool can potentially outline the sustainable footprint of a company. Not only in ways of static ESG ratings but rather in detecting companies endeavours towards a more sustainable economy and society. Especially companies with a current more negative ESG reputation can be assessed in their potential transition towards more responsible and impactful business activities. This can help to identify potential investment opportunities early on by analysing which companies are ready to change or even already moving to become more sustainable in the future.

Whilst not neglecting analysis and reporting of traditional data, for Universal-Investment, News-based ESG Scoring is an important step towards the integration of sustainability risks and the recognition of potential investment opportunities. The cooperation with YUKKA LAB is a great example of how to facilitate networking between players, create transparency and establish reliable standards for an industry that evolves at a fast pace – contributing to shaping the future of the investment management industry.