MAY 2024

Strengthening the S in ESG

GUARDRAIL

02 Avoid indicators that encourage unjustified conclusions.

INTRODUCTION

This is Part 2 of Shift's Strengthening the S in ESG Series focused on designing better social indicators and metrics. It is based on our analysis of almost 1300 indicators and metrics used in ESG data providers' products or reporting requirements. Approximately 700 of these are social indicators used by five major ESG data providers,[1] 225 are governance indicators used by these same providers and 350 are social indicators used in global or regional reporting frameworks.

Shift's findings are structured around three guardrails (what to avoid in indicator design) and three guidelines (what to aim for in indicator design) to support the use and design of effective social indicators and metrics. For an introduction to the series, **please visit our webpage**.

1 Shift was unable to verify whether the non-public indicators and metrics that we used for our analysis are the most up to date versions used by data providers at the time of writing (April 2024). Shift recognizes that the underlying methodologies used to reach a judgement on a company's performance against an indicator may offer more nuance than we were could not access for our research.

GUARDRAIL TWO

AVOID INDICATORS THAT ENCOURAGE UNJUSTIFIED CONCLUSIONS.

A large proportion of S in ESG indicators, metrics and approaches encourage users to reach inaccurate or questionable conclusions. This shows up in:

1. composite indicators that make outsized claims about companies' social performance;
2. indicators with a weak causal link to practices being implied; and
3. indicators that are impossible to interpret without context.

Some of the indicators we identified as problematic should simply be taken out of circulation. Others could be adapted to avoid crossing the guardrail.

13% of the ~700 'S' indicators used by data providers encourage unjustified conclusions.

THE GUARDRAIL EXPLAINED

Insights from ESG data are intended to drive action, primarily by investors. But if investors have extrapolated unjustified conclusions from this data, capital allocation and investment stewardship decisions will not reliably reward those companies that are performing best when it comes to anticipating and managing adverse impacts on people and planet. This risk can be especially acute in relation to the S in ESG because investors and other stakeholders are often unfamiliar with the field, the standards used and the areas of practice being evaluated. While some investors are growing that expertise within their organization, it is inefficient to rely on each investor having to interrogate data and (as we commonly see) supplement it with their own in-house analysis.

RESEARCH FINDINGS

01 Multiple data providers are using composite indicators that make outsized claims about companies' social performance.

Composite indicators are combinations of individual data points that represent different dimensions of a concept being measured. They can simplify complex, multi-dimensional realities into something more easily understood and communicated. But composite indicators can also oversimplify complex phenomena due to the subjective selection and arbitrary weighting of inputs. In addition, when the methodologies underlying such indicators are proprietary, opaque, or not subject to expert review, it is hard to make the case that they are reliable.

It is common for ESG data providers to use composite indicators that profess to evaluate whether companies conduct all of their business operations and activities in alignment with the OECD Guidelines on Responsible Business Conduct, UN Guiding Principles on Business and Human Rights, the ILO core conventions or certain voluntary codes. In reality, this will rarely be the case because the expectations in these international standards are extensive and complex, while the underlying data points used by an analyst to reach an opinion to score a company tend to be vastly simplified. Analysts might only be looking at whether a company has a policy that commits to these principles, or discloses programs and processes focused on one or two aspects of these expectations rather than the full, holistic scope of these standards. As such, claims based on these types of indicators are often outsized.

We also see indicators that appear to offer an evaluation of a company's overall human rights performance based on evidence that the company has done something – anything – on one impact listed in the composite indicator (e.g., child labor, forced labor, excessive working hours, living wages or collective bargaining). Indicators that credit a company for implementing a single, unspecified action or practice concerning one issue from a longer list, could legitimately be used to screen for laggards. But they cannot offer insight into a company's general social performance, nor even into discrete aspects of its business, such as its supply chain.

COMMON EXAMPLES OF INDICATORS THAT MAKE OUTSIZED CLAIMS

The company...

- follows the OECD Guidelines.
- follows the UN Guiding Principles on Business and Human Rights.
- abides by the Universal Declaration of human rights.
- has implemented any initiatives to reduce social risks in its supply chain.
- commits to prevent violations of human rights across its suppliers' operations (workers' health and safety, minimum living wages and maximum working hours, freedom of association and the right to collective bargaining, child and forced labor, acceptable living conditions, non-discrimination, and disciplinary practices).

TIP

MAKE METHODOLOGIES TRANSPARENT

To make composite indicators credible, ESG data providers should engage credible experts to review the methodologies underpinning them and be transparent about how those methodologies are applied – for example, by sharing examples of assessment with the underlying data and weightings used to arrive at scores.

RESEARCH FINDINGS

02 Too many indicators measure phenomena with a weak causal link to practices being implied.

Too often, S in ESG indicators focus on the fact that something exists, such as a policy, training program, or documented process, without offering insight into the quality of its content or implementation. In addition to the issues outlined above, this often means that data providers are evaluating company actions that have, at best, a weak causal link to the effective identification and management of risks to people and business. At worst, evidence from practice shows that in many cases there is no such link at all. So, information that a company trains x% of its employees on human rights risks, or that ESG factors are part of leaders' performance incentives, is of little value without insight into the quality and effectiveness of those programs.

Similar pitfalls frequently arise when ESG data providers place value on whether a company is a signatory or participant in an industry initiative related to human rights. Typically, the information captured is merely about whether a company has signed up to an initiative, not how the company uses its participation to align with the initiative's principles and goals and improve its practices. There is plenty of evidence of companies participating in these initiatives without discernible effects on their own practices. The reverse is also true: many companies have advanced practices but are not signatories to these efforts.

A subset of indicators with a weak causal link to a company's social performance are those that measure the presence of good commercial business practices but offer no insight into a company's management of impacts on the human rights of workers, communities and consumers. For example, indicators that a company is engaging suppliers on quality management systems does not say anything about their engagement on labor rights. Similarly, indicators focused on customer feedback and satisfaction should not be used to infer a company's attention to risks such as discriminatory pricing or product-related health risks, of which customers may be unaware. Including such indicators in the S in ESG risks misleading investors and users of ESG data.

EXAMPLE INDICATORS WITH WEAK CAUSAL LINKS TO EFFECTIVE MANAGEMENT OF RISKS TO PEOPLE AND BUSINESS

The company…

- has a labor-related policy/code of conduct for its own workforce on anti-discrimination.
- has a labor-related policy/code of conduct for its own workforce on Freedom of Association.
- has a statement or policy on human rights.
- is a signatory of the UN Global Compact.
- links its management's bonuses to the achievement of non-financial performance goals.
- conducts training for its employees on Corporate Social Responsibility.
- provides training on its supplier code of conduct.
- participates in, or is a formal member of, a recognized human rights initiative.
- or its suppliers are members of of an industry initiative that addresses labor rights issues.
- measures the percentage of satisfied clients.
- conducts supplier training on quality assurance.

RESEARCH FINDINGS

03 Data providers use indicators that are impossible to interpret without context.

In their analysis, ESG data providers typically include indicators focused on media reports or allegations implicating a company in negative impacts on workers, communities or consumers. However, while a low number of allegations could indicate good management of human rights impacts, it could equally reflect limited media or public attention to the company in question: for example, because it is a mid-size, B2B company, or a company headquartered in a market with limitations on civil society research and advocacy.

Interpreting allegation data is further complicated by the fact that past events are not always the best predictors of current and future practice. It is not uncommon for negative events to spur companies into action, or even adopting market-leading practices; but that action will rarely garner media attention and it may be months until it is reported in public disclosures. In sum, when considered in isolation, without research into the specific company in question, allegations indicators offer, at best, ambiguous insight into a company's current or future practices.

Some indicators seek to measure legally-required performance on certain issues. These include indicators focused on government requirements to employ local nationals as a condition for licensing and investment (so called "local content" demands), the chemical composition of products, and requirements regarding privacy or modern slavery reporting where this is legally mandated. The problem is that where a company is simply complying with specific legal requirements on such issues, this gives no insight into whether a company is seeking to address its most significant human rights impacts across its operations and value chain.

EXAMPLE INDICATORS THAT ARE HARD TO INTERPRET WITHOUT CONTEXT

- Company involvement in incidents, complaints, or grievances relating to the communities in which it operates.
- The number of severe and very severe controversies related to labor management relations (including collective bargaining and union issues).
- The number of controversies related to sourcing in which the company has been involved.
- Involvement in and management of crisis situations that may have a damaging effect on reputation.

The company...

- has a statement on the Modern Slavery Act or equivalent legislation for its jurisdiction.
- has implemented initiatives to ensure consumer data protection and privacy.
- declares the chemical composition of its products, either on its labelling or on its website.
- has hired senior level positions from the local community.

TIP

REPURPOSE ALLEGATIONS INDICATORS

ESG data providers could repurpose allegations data such that investors can use it for conducting company specific due diligence instead or portfolio screening. This might open up greater opportunities for bespoke collaborations with investors interested in more granular and up-to-date information on a sub-set of companies that they have already prioritized for engagement.

WHEN DATA IS GOOD FOR DUE DILIGENCE BUT BAD FOR RATINGS AND RANKINGS.

This Guardrail spotlights indicators focused on policies, training, participation in industry initiatives, allegations and legal compliance. The message is not that executives and managers should not use this data to inform their decision-making – but rather that it should not be used to score a company's overall S performance, nor as a basis for comparison across companies. Instead, this sort of data can be useful to informing a company's due diligence processes by highlighting gaps and increasing internal accountability for the management of risks.

The same is true for investors' use of third-party data on allegations. This can be useful for an investor as part of company-specific due diligence in which they may interrogate how the allegations arose and what the company is doing about them, including any actions to prevent recurrence. But the data point of allegations alone is not a good basis for comparison across companies, since it is often unclear how a company is connected to the issue and whether it has responded appropriately and learned lessons (thus reducing risk, not increasing it). Moreover, plenty of other companies may have the same issues that do not show up in the media or other sources used by data providers to track allegations.

LOOKING AHEAD

Data providers can avoid using indicators to reach unjustified conclusions by seeking input from credible experts to improve those methodologies underpinning the data points and removing indicators that fail expert review. Greater transparency to investors about the methodologies used for scoring is also key, ideally with clear labelling for users so that they better understand the scope and limitations of indicators.

In addition, data providers should use design principles that will deliver indicators and metrics that can bring greater value to both the measurement and assessment of progress. In this series, we propose three design principles:

1. Use indicators that are strong predictors of business decision-making and behavior.
2. Use indicators that give insight into the scope and quality of risk management.
3. Use indicators that offer insight into a company's contribution to positive outcomes for people.

For more information, please visit our webpage.