SUSTAINALYTICS

a Morningstar company

THE ESG RISK RATINGS

MATERIAL ESG ISSUE – DATA PRIVACY AND SECURITY



Sustainalytics' Material ESG Issue: Data Privacy and Security

Data privacy and cybersecurity-related issues have become major drivers of business risk in the past several years. In 2020, cybersecurity topped the Allianz Risk Barometer for the first time since its inception, rising to #1 from #5 in just 5 years.[1] Sustainalytics considers Privacy and Security a material ESG issue (MEI). The Privacy and Security MEI shows investors which companies are most exposed to this risk and how well they are managing it. In this backgrounder, we will examine why this issue is growing in importance, analyze which industries are most exposed to this issue and highlight companies that perform well on this material ESG issue.

The Growing Importance of Data Privacy and Security

As companies digitize and business models shift toward complex data-driven supply chains, stakeholders are reckoning with a significant realignment in global risk. Personal information has become an essential commodity and the cost of failing to protect it continues to increase as customer awareness grows in time with more stringent privacy laws, such as the *General Data Protection Regulation* (GDPR). EY's 2020 Global Information Security Survey found that 59% of organizations have faced a material or significant incident in the past year and 48% of boards believe that cyber-attacks and data breaches will more than moderately impact their business in the next year.[2] Sustainalytics' own data bears this out: the number of privacy and cybersecurity incidents is on track to increase 4-fold in 2020 compared to 2015.[3]

The financial impact of a data breach can be significant. According to the 2020 version of the well-known IBM Cost of Data Breach Study, the average total cost of a data breach was USD 3.86 million with the US being the most expensive jurisdiction, coming in at USD 8.64 million per breach. Globally, the healthcare industry was the most expensive at USD 7.13 million per breach, unsurprising given the sensitivity of the data captured in that sector, and the special provisions in privacy law for this type of information, both in the US and Europe.[4] It is equally important to recognize the financial, regulatory, and reputational risks that arise not just from cyberthreats and data breaches, but also from concerns around perceived misuse and/or lack of transparency. These privacy issues and associated controversies impact some of the most valuable companies in the market.

Assessing the Unmanaged Risk of Privacy and Security by Industry

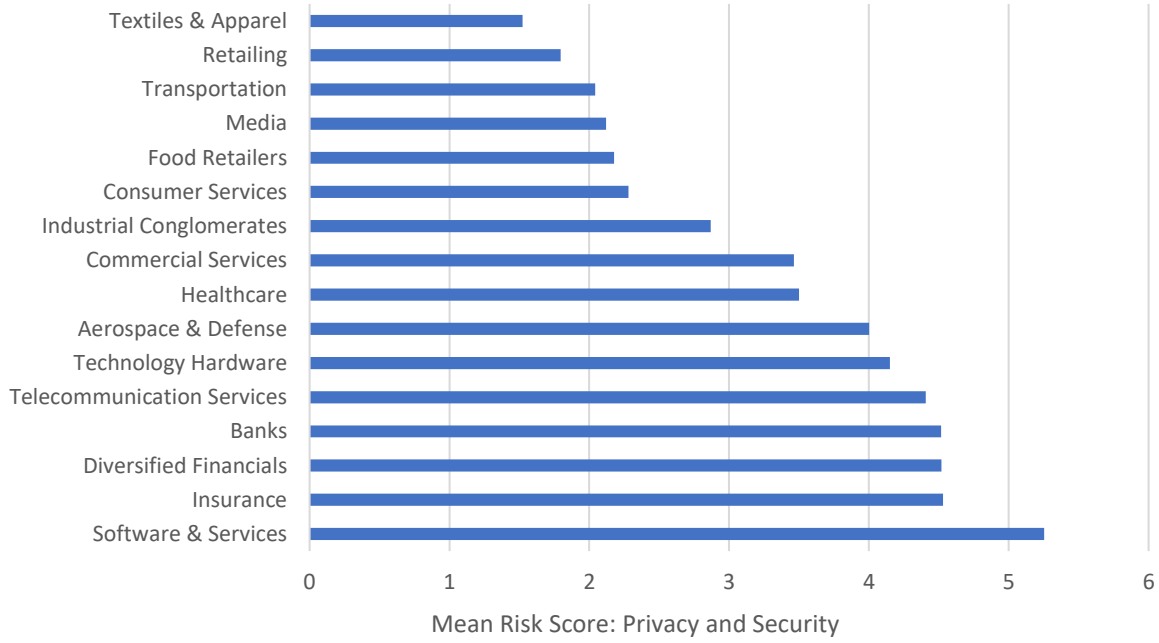
Within the ESG Risk Ratings, Sustainalytics' assessment of Data Privacy and Security considers both the risk a company *cannot* manage due the nature of its business model and the quality (or lack thereof) of its management practices. These practices include policy commitments, programs, and measures of transparency. Business model-related risk tends to be a function of the volume, breadth, sensitivity, and/or use of the personal information in question, along with any inherent strengths or weaknesses of the systems or software in question. Management practices that mitigate risk include policies related to appropriate collection, use, disclosure, and safeguarding of personal information, along with a commitment to respect a consumer's privacy rights and transparency around the mechanisms they can

[1] https://www.agcs.allianz.com/news-and-insights/reports/allianz-risk-barometer.html
[2] https://www.ey.com/en_ca/giss
[3] Data generated November 4, 2020
[4] https://www.ibm.com/security/data-breach

use to exercise them. These policy commitments should be put into practice through industry-standard privacy and cybersecurity programs and effective reporting.

Applying our ESG Risk Ratings model, we see that Privacy and Security is material for over 2,000 companies in our comprehensive universe of more than 5,000 companies, spanning 19 industries and 56 subindustries. As indicated in Exhibit 1 below, companies in the technology space have the highest unmanaged risk scores on average, followed by financial services and aerospace & defense.

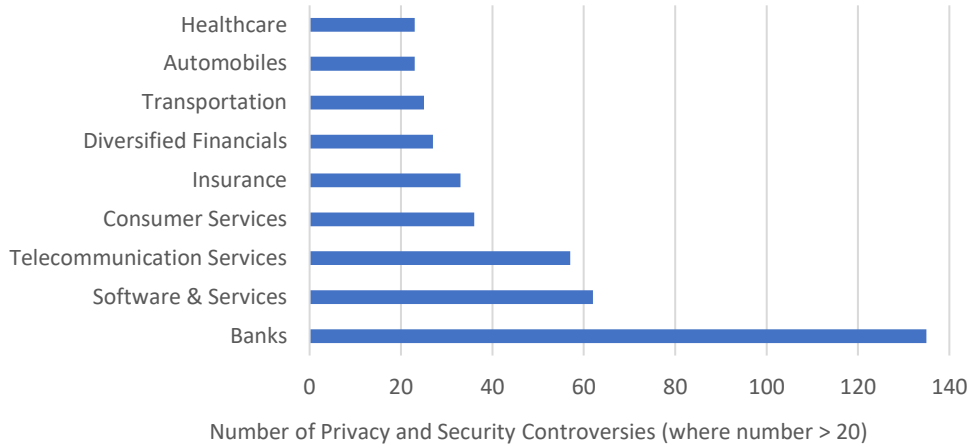
Exhibit 1: Privacy and Security: Unmanaged Risk by Industry



(Source: Sustainalytics, Data as of November 2020)

Unmanaged risk also includes incidents and controversies that are related to certain business models (e.g. social media), and/or a failure to properly manage risk through policies and programs. These are captured through Sustainalytics screening of more than 60,000 news items, third-party sources, and company and regulator reporting. A total of almost 700 companies in our comprehensive universe are currently dealing with a Privacy and Security controversy, with the heaviest burden in the technology and financial sectors, as indicated in Exhibit 2, below.

Exhibit 2: Controversies by Industry



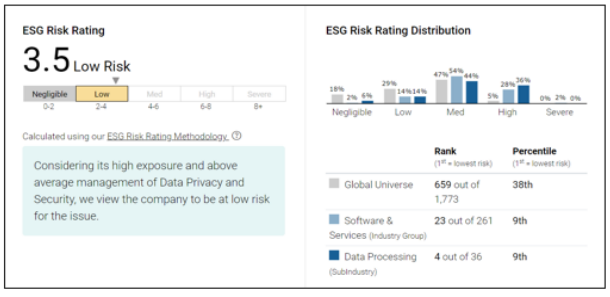
(Source: Sustainalytics, Data as of November 2020)

For this issue, controversies include cyberattacks, data breaches, civil litigation, regulatory investigations, public concerns over surveillance, profiling and/or misuse of data, penalties, and fines.

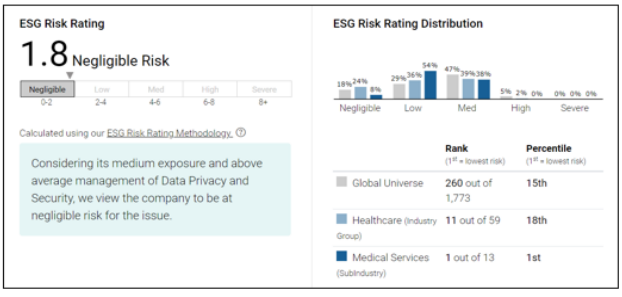
How Sustainalytics' Evaluates Companies on Privacy and Security

Leveraging our ESG Risk Ratings framework, we score companies on a set of subindustry-specific exposure and management indicators. Exposure criteria include the perceived market and "prestige" value of the data, its breadth and volume, sensitivity, business model, and the extent of digitization or data supply chain in the subindustry. Key management controls include policy commitments, programs and measures of transparency. From these criteria, we calibrate the exposure and management indicators for each subindustry.

Focusing on the technology and healthcare space, we will focus on two companies whose management practices are strong and serve to significantly offset their relatively high degrees of exposure. These companies are Mastercard and Laboratory Corporation of America Holdings.



Source: Sustainalytics ESG Risk Rating Report, Mastercard



Source: Sustainalytics ESG Risk Rating Report, Laboratory Corporation of America Holdings

Mastercard is the second-largest payment processor in the world and processed $4.8 trillion in purchase transactions in 2019. The company's exposure to Privacy and Security issues is high, and significantly above industry average: its network is a lucrative target for organizations seeking to access valuable information on financial transactions and its global footprint ensures it is subject to a variety of evolving privacy and data security-related regulations and compliance frameworks. Nevertheless, Mastercard's strong management of this issue ultimately places it within the Low Risk category for Privacy and Security, putting it within the 10th percentile for its subindustry. The company's privacy and security policy commitments, robust programs, and above average transparency provide a robust mitigant to its very high exposure to this material issue.

As one of the two largest independent clinical laboratories in the US, the Laboratory Corporation of America Holdings (LH) is another example of a company that is following best practice to reduce privacy and cybersecurity risk. As a subindustry, Medical Services are significantly exposed to these risks: they process large volumes of sensitive data, within a highly complex regulatory environment. However, LH's leading management practices place it within the Negligible Risk category for Privacy and Security, the lowest within its subindustry.

A Privacy and Security "Race to the Top"?

The collection and processing of personal information has become one of the most significant drivers of financial value in the global economy. It has become an essential commodity and the cost of failing to protect it continues to increase as customer awareness grows in time with more stringent privacy laws, such as the *General Data Protection Regulation* (GDPR). Under the latter, privacy violations can result in fines of up to EUR 20 million or 4% of global turnover, whichever is greater. The GDPR has also begun a "race to the top" in which countries attempt to keep up with the GDPR standards to protect global trading relationships and meet increased consumer demand for protections. By leveraging our ESG Risk Ratings, investors can clearly see which companies are most exposed to this key issue and how well they are managing their related risks.



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