SESSION SUMMARY - BERLIN SEPTEMBER 2020

Sustainability disclosures: progress made and possible new challenges

1. Sustainability disclosures are essential for improving investment risks and impact assessments, triggering behavioural change in financial markets, participants and investors, and further involving citizens and retail investors in the transition

A policy maker outlined how correct disclosures of non financial information are critical for the EU's sustainable finance strategy, as financial market participants and investors need comparable and reliable non financial information to understand the risks of their investments. This is a key pillar of the European green strategy. The Commission aims to create, via disclosures, more incentives for a real behavioural change in financial markets to accelerate the transition towards more sustainable investments. In addition, this policy offers an opportunity to involve more ordinary people and retail investors in that transition.

The EU has already adopted a common taxonomy that defines sustainable economic activity, so that market participants can better focus their investment strategies. The Commission is going further with a legislative proposal to revise the non financial reporting directive (NFRD) to improve the availability, quality and reliability of sustainability disclosures by investee companies.

2. Policy challenges regarding sustainability disclosures

This panel took stock of the Commission's policy, its achievements, what is working and what remains to be done. The discussion started with the benefits of sustainability disclosures and whether they are on the right track. But even if all agreed that future policy is promising, there would still be some policy and regulatory challenges to be addressed for the transition to be successful.

A regulator congratulated the EU on its approach. When the transparency regulatory proposals were launched, this regulator was initially sceptical, as usually a taxonomy is the starting point to constructing a regulatory framework. Doing it the other way round worked this time, as now both are available at once, allowing disclosure requirements to commence. The second big task is to make greenwashing less possible. This mandates a harmonised and reliable approach towards sustainability.

An official described how corporate non financial reporting could be seen as an opportunity rather than a challenge. Without corporate reporting, investors cannot be provided with reliable information in order to pave the way for the ESG transition. But these requirements can also be a challenge, so any approach to building European reporting must be pragmatic, harmonised and reliable. The official recognised that there is an emergency here, and it is essential to improve the resilience of both financial institutions and investments to master the financial risk induced by climate change and ESG factors. As a consequence, financial institutions should appropriate these risks in their strategy and their risk management. Legislation will help in that matter.

An industry representative pointed out that disclosure requirements had been voluntary for decades but, in recent years, there has been an increasing demand, both from clients and public institutions, for more granular, consistent and comprehensive data on ESG factors. Another industry representative agreed on the need for more reliable information, welcoming the European Commission's initiatives in that regard, and voicing their support for a pragmatic approach. In the official's view, there is an opportunity for reporting to cover the whole value-chain and hence incorporate suppliers' ESG information, but the cost must be reasonable and manageable for it to have value.

3. Regulatory challenges of the EU Commission in the global context

3.1 The EU should have a leading role in the definition of the much-awaited global standard

An industry representative reported that, in Japan, around 300 private sector companies from all sectors have voluntarily established consortia to follow disclosure guidance, supported by cooperation from government agencies. This is a valuable reference for the EU. Likewise, the systemically important global banks are endorsing a number of voluntary ESG guidelines covering investing and lending activities.

Another industry representative saw a great opportunity for the EU to set a global standard and become a global leader in this area. The taxonomy regulations show what can be achieved and, although steady progress has been made, this work is not yet completed. From these meaningful concepts, the EU has a real chance to become a global lighthouse. The general data protection regulation (GDPR) is a benchmark here, and gives cause for optimism in developing a consistent and aligned framework.

The first industry representative stressed the importance of global alignment, citing an IFI study that counted nearly 200 policies and regulatory measures on ESG disclosures, across nearly 40 countries. This is too many and only leads to inconsistencies. The various ESG disclosures and reporting guidelines have to be aligned and harmonised before integrating them into mandatory frameworks. The future for non financial reporting standards should ultimately cover all ESG topics, not only climate risk, and must avoid fragmentation in the scope of disclosures. It is essential to ensure that international voluntary ESG standards are complete and consistent, as they are vital for strengthening the sustainability of the financial system in the world's path to net zero.

The regulator (Pierschel) has full support for what the Commission is doing. When globalising its approach, it should not spend too much time convincing others. Pressure can be placed on other countries just by requiring the same standards of supply chains.

3.2 Building an EU harmonised sustainability database is necessary, while making firm specific strategic information available should allow a dynamic assessment of risk and investment attractiveness

An industry representative is planning an EU wide, centralised, open access and free database for sustainability and non financial information. This will enable the regulations to be used more widely beyond Europe. The official considered the NFRD a necessary step, since the way corporates are currently reporting makes it difficult for financial institutions to compare two companies' ESG approaches. In the current state, simple materiality expresses the financial cost of ESG risks on the corporate. Dual materiality is essential, both for corporates' and investors' analysis. This could help progress to an approach where economic players see how their actions impact their environment and how they can contribute to the improvement of ESG factors.

An industry representative focused on how disclosure information is currently used and opportunities around NFRD and sustainable finance disclosure regulation (SFDR) reforms. Consistent and comparable data is important but is not the whole story. More interesting are the specifics of how a company identifies, assesses and manages sustainability related financial risks, and how it determines if an issue is material and therefore characterises the risk reward profile of a firm.

3.3 The NFRD should help EU companies to navigate the complex reporting landscape

An investor representative described how companies with good or improving ESG characteristics are attractive to active investors. As the broader context is key, reporting on more strategic issues is preferred. Reporting frameworks, such as the integrated reporting framework and the Task Force on Climate related Financial Disclosures, are much more dynamic. Other reporting frameworks miss that forward looking strategic focus.

It can be frustrating for companies that there are so many different reporting frameworks out there, but which serve different purposes. The Sustainability Accounting Standards Board (SASB) looks at near term contingent financial risk, while the Global Reporting Initiative (GRI) and the Sustainability Development Goals (SDGs) have more of a public policy focus. With such a crowded field, the NFRD has to be welcomed. At best, it will help companies to navigate the reporting landscape, but there are risks of oversimplifying a set of complex and intertwined issues to the point of becoming a tick box exercise.

Before moving on to the challenges for future policy, a policy maker wanted to hear the industry representatives' views on what has already been agreed for the new SFDR on non financial reporting and whether they have detected any potential problems. A text should start to apply in the coming months.

4. Although transitioning is urgent, further attention should be paid to the current legislative process and planning in the EU, since sustainability disclosure regulations impact long term irreversible decisions and the investment-financing value chain is complex and international

The first industry representative (Bücheler) to comment perceives challenges with the timeline, particularly as the level-one regulations are applicable before level two is ready. More of a phased approach is to be preferred. This is a long term business as, when buying life insurance or old age provision, customers sometimes look 20 or 30 years ahead, yet sellers might only offer assurances about the sustainability of these investments here and now. The timetable between levels one and two for sustainable financial reporting and disclosure regulations is difficult. The NFRD is similar because, as good as its intentions are, it is currently only envisioned for 2023.

The industry representative gave the example of the 'do no significant harm' assessment, which is reflected in the SFDR, and the principal adverse impact assessment, which is in the NFRD. Both basically address the same issue that if, for example, a company is CO_2 friendly, it does not do other damage to the environment. But their definitions are different. These things need to be nailed down if the European industry is to cooperate with the IFRS Foundation and other global players.

The policy maker described the issue with the timetable for implementation. The level one text was meant to be applied before the technical standards were ready. The regulator feared that postponement of the framework's entry into application is impossible. Participants will have to live with the framework as it is for now. As soon as the information is there to be used for disclosure requirements, it can be. If not, the financial industry should not be blamed. Financial companies are not exposed to sustainability risk per se. They carry a huge amount of reputational risk, which is already covered by solvency regulations, but an insurance company or bank is exposed indirectly via its loan granting, insurance and investment businesses. That is where non financial information is needed, and as soon as possible.

An industry representative thinks the moment should be seized to make society greener, where the EU could be a frontrunner for global ESG initiatives. Another industry representative fully supported the direction of the European Commission's activities here but cautioned that time is needed to properly align the EU taxonomy with the regulatory technical standards. For example, the 'do no significant harm' principle must align with the principal adverse impacts, and clarity is also required on ESG strategy products.

5. The scope of the NFRD should be widened for SMEs, which requires the adoption of proportional regulatory approaches

A regulator wants non financial reporting to be widened from the current arrangements, so that it applies not just to listed companies, but to all other corporates. Some SMEs may only comprise around 50 people, but have turnovers of €2 or €3 billion, because their factories are automated. To encompass those, a combination of number of staff and turnover figures might be applied, widening the scope of the NFRD. A policy maker stated that there has to be a trade off between such a widened scope and the burden that would then fall on small non financial corporates, which would call loudly for more of a proportional approach.

6. Designing an efficient sustainable-disclosure value chain in the EU raises many challenges

There is a sustainable disclosure value chain, which begins by gathering quantitative and qualitative data, then makes sure there are quick to understand indicators and ratings. The panellists were asked if the Commission should pay more attention to certain links in this chain or if all are equally important.

6.1 Incentivising individuals' sustainable financial investment requires making appropriate and consistent definitions available

One issue not touched on yet was the sustainability preferences being included in the suitability tests for MiFID and the insurance directive. An industry representative felt that it made sense to incentivise customers to take up sustainable products, but whether such products could be offered depended on reporting definitions. According to this speaker's firm information, all their life insurance products are currently sustainable, because investments are being monitored for ESG compliance. Following a channel approach makes sense and might help solve this reporting conundrum.

6.2 The provision of data raises critical issues, such as the relevant timeline of the project, the existing asymmetry of information, proportionality challenges and over concentrated data providers

An official contended that ESG data had already been seen as a strong lever for innovation in the market, but some think the market is not functioning well. There is an asymmetry of information and a high level of concentration, which results in barriers to entry for new players. There is a need for an EU regulation applying to all ESG data-related products and services on the market (e.g. ESG rating, scoring, etc.). The scope for this regulation should be wide and not too prescriptive. It should ensure transparency around the methodologies that providers have employed and must include some quality criteria. An industry representative commented on this that some data providers are supplying opinions, not facts. It might be difficult to determine that one piece of advice is better than another without an understanding of what methodologies and assumptions are going into the data and metrics they have provided. The Commission could make sure there is better transparency, giving users a kind of health warning.

A regulator advised first taking advantage of the taxonomy. This has to start now, mainly with qualitative information, and cannot wait for the perfect solution. Sooner or later, the picture will become clearer and shifts can be made to more quantitative reporting. The regulator pleaded for a publicly funded data pool, from which all ESG data can be drawn. That data should be as raw as possible to enable everybody to deliver the disclosures required. Proportionality had been mentioned, but the usability of data is another issue. It does not make any sense to disclose data if there are no possible comparators for it. Like their colleagues, the official also strongly believed in the opportunity of building a European open access database for ESG data. It would be extremely valuable for the development of a forward looking approach, allow for more competition on the market of ESG data analysis, and improve corporate data comparability in the ESG sphere.

6.3 The design of an efficient sustainable-disclosure value chain should leverage the stewardship of financial institutions by providing a longer-term view of the strategies of ESG firms

An industry representative saw that, although regulating the supply side of information is important, consideration needs to be given to what investors are doing with the data. There is a gap in Europe's regulatory agenda concerning stewardship, as the sustainable finance reforms being proposed are focused more on consumer protection and reallocating capital away from climate damaging activities, rather than on the active role that investors can play in driving positive change. Stewardship is the act of investors using their ownership rights to engage with companies where they identify risks and challenge them to do more with their capital expenditure and product design to shift from the unsustainable to the sustainable.

Another industry representative echoed those comments. It would be interesting to see how doing nothing affects a company's shares over time. They are strongly expected to go down. Some industries or companies that have a high polluting standard today can contribute a great deal to reducing it if they made the right investments and changed their business models now. This requires forward looking information from companies with 5 to 10 year pathways showing how they plan to reduce CO_2. Care needs to be taken around complexity, in this context.

6.4 A level playing field is needed between listed and non listed companies

An official thought a level playing field is first needed, in which listed and non listed companies would be placed on an equal footing, because the latter are also able to engage in non financial reporting. This is being demanded by clients, but employees also want to work for an organisation that pursues ESG goals. Second, many SMEs are already reporting voluntarily and are able to handle up to 100 ESG indicators. The Commission should study how to develop a proportional approach in providing a framework to SMEs in their reporting, not only on the E pillar, but also on S and G factors. After that, if companies wish to report more, this could be facilitated.

Most important is that a common EU approach is followed, which means standardisation, so that indicators for reporting are consistent with all the policies that already exist on ESG. The inputs of the industry will help to build consistent reporting, while the existing frameworks used by many corporates provide a useful starting point. Many of the panellists are optimistic about the ambitions of a revised NFRD. ■