PROSPECTS OF GLOBAL AND EU ESG STANDARDS CONVERGING

1. ESG standards: what is at stake

1.1 Encouraged by the actual correlation between financial and non-financial performance, investors play a key role in leading companies to addressing essential challenges of current generations

An official commented that a single shared, standardised language is needed for corporate information. The biggest challenge of this generation, in addition to COVID-19, is climate change and the related social inequalities and human rights violations. To tackle this, companies are required to be sustainable to make it easier for them to receive funding.

An industry representative explained that the sustainable finance package originally intended that disclosure would change the behaviour of the underlying companies that need the capital flows, either from investors or the banking and insurance vectors.

Another industry representative stated that active asset managers use data that corporates disclose to help their transition. Different frameworks can make reporting burdensome for issuers. There is increased data evidence of a correlation between financial and non-financial performance. Current investment decisions are therefore also based on non-financial data, already in current decision making even ahead of respective regulatory obligations coming into force.

An industry representative reported that the top three reasons given in the Zeronomics survey for organisations not fully supporting the aims of the Paris Agreement were a lack of finance, the need for regulatory certainty and the lack of clear standards on the net zero definition and targets. Standard Chartered Bank is supportive of the International Platform on Sustainable Finance (IPSF) and grateful for the work of the International Organization of Securities Commissions (IOSCO).

1.2 Companies' disclosures are essential to empower investors and enable a sustainability dynamic

An official noted that policymakers and regulators aim to avoid unintended side effects on the efficient functioning of the financial markets. Transparency and standardisation are at the centre of international debate.

An industry representative commented that investor demand for ESG funds is rising. The supply from asset managers is increasing, with the sustainable finance disclosure regulation (SFDR) article 8 and 9 products coming to the market. The asset management industry is starting to integrate more ESG factors into the investment process. The foundation and nucleus of all this is corporate disclosures.

1.3 There is an opportunity to leverage the increasing global political alignment to deliver transparent, comparable, and standardised information

An official commented that there is an urgent need for public and private standard setters on non financial information to deliver consistency and compatibility. There is still no single definition of sustainability.

2. Policymakers' efforts at EU and global levels

2.1 The EU is now focusing on making the Non Financial Reporting Directive consistent with the various recent ESG initiatives

A policymaker indicated that the non financial reporting directive (NFRD) will be reviewed and updated to ensure it is consistent with other EU legislative interventions.

2.2 This review is part of the Commission's agenda to foster sustainability transition, which also represents a recovery opportunity for the EU in the Covid-19 crisis context

A policymaker confirmed that sustainable finance is high on the Commission's agenda. Sustainable finance is a part of the Commission's plan for a quick, efficient, and sustained recovery.

2.3 NFRD: giving the investors the detailed and precise information that they need and addressing information consistency and comparability issues at the European level

A policymaker explained that the NFRD review aims to widen the scope of the NFRD. Obligations stemming from the directive will be made more concrete, detailed and specific. The directive covers sustainability in the ESG interpretation, including social issues, human rights, and governance. Standards are different everywhere. Information is not comparable and therefore not useful for investors. Some companies do not report at all. European standards for reporting on non-financial issues will build on and coordinate with standards that already exist.

2.4 The focus of policymakers should also be on making the information needed assurable

An official commented that the public sector is needed because, no matter how effective the work of market participants, consistency and comparability in reporting is necessary. Public sector intervention ensures that information is assurable.

3. Although human capital is an actual priority in the EU, related value-creation metrics and information require steep improvements

An industry representative noted that there is agreement among most speakers on the need for comparability, global standards and ensuring any actions are useful for end investors and companies. Focus should be on human capital and practical suggestions. The NFRD was one of the first reporting standards that included human capital and a need for diversity data. In analysis carried out by their Group, human capital is of equal importance to other ESG considerations (as climate change), but there is very little reporting on it.

An industry representative advised that frameworks should align with the sustainable development goals (SDGs). Covid has highlighted the importance of inequality. Without human capital, no economy or company can remain competitive. International collaboration could begin around an issue as simple as human capital. The Securities and Exchange Commission (SEC) has recently noted the importance of human capital. Companies are requesting simple, clear, understandable metrics. Europe is doing well on diversity of workforce but lagging on diversity of senior management. Better data on global breakdown of ethnic diversity and how companies invest in the workforce is needed. Human capital would be a great platform to ensure the S is included in ESG and to get strong international collaboration.

4. Emerging markets should be further considered to progress climate change issues

An industry representative noted that the biggest and fastest source of emissions now, and the area that has suffered almost twice as much damage already from climate change, is the emerging markets. It is also where there is the biggest opportunity to leapfrog to low-carbon business models. There is a lack of capital going into tackling sustainability in these areas. Feedback has been received from investors and other actors around the lack of common standards. Standards should encourage capital to move to where it can have a huge impact.

5. The journey toward convergence starts with meaningful, monitored and verifiable data

An industry representative commented that basic information can be built on. The largest companies can make the biggest difference in the shortest time, so the initial focus should be on reporting by large companies. The required quality and consistency of data is not present in the financial services sector now. When data is in the audited accounts, it is possible to have a reasonable definition of what is assured and what has an opinion against it. When it is presented as a non-financial disclosure, it should not be a marketing document.

6. A centrally developed set of standards might lack agility and fail to deliver an optimal flow of capital

6.1 Frameworks are often static and backward looking, which leads to lost development opportunities and industry-specific transition pathways being ignored

An official stated that well-functioning capital markets enable capital to flow to the people who can use it best. Pre-planned capital markets operating according to a centrally developed set of standards cannot do this, because they channel money to wherever the people who wrote those standards thought would be the source of the solutions. Issuers and investors want a common framework, but the price of that framework will be high in terms of lost opportunities.

6.2 Information on the transition pathway and comparisons of the impact of investments should improve capital allocation globally

An industry representative emphasised the importance of a definition of transition. Reporting and definitional frameworks in the green markets are often static and backward looking. The technologies that will drive the future are unknown. Several industry-wide transition pathways across eight of the most carbon intensive industries will be published later in the current year. The banking and finance sector tends to celebrate volume over almost everything else, often at the expense of impact. Where and what is just as important as how much.

An official commented that the aim is the creation of a market that delivers the outcomes that public policy is seeking to achieve.

7. A framework for markets that can operate across borders is needed. However, balancing regional priorities will be challenging

7.1 A framework for markets that can operate across borders is needed

An official reported that the UK was the first country to announce its intention to make TCFD disclosures fully mandatory across the economy by 2025. The EU's ambition on sustainability reporting has been world leading. The NFRD will significantly strengthen sustainability reporting. International activity is needed because no one jurisdiction can fund a shift on its own. There are real-world geographical differences in how objectives will be achieved. A set of baseline international sustainability standards is needed, building from the TCFD architecture. In addition, individual jurisdictions have to develop their own disclosure requirements.

7.2 Existing regional or national ESG preferences and philosophies that are reflected in regulations raise competition and comparability concerns: a global solution is necessary

An industry representative commented that regulations inform the investors' definition of ESG. On the supply side, capital flows are international, and corporates operate with global supply chains. Diverging ESG rules across the globe make comparability difficult. There is also the potential challenge of corporates exploiting regulatory arbitrage across global supply chains. The NFRD is wider in scope than the TCFD and has a dual materiality approach, meaning that the data is not comparable.

An official commented that ESG is an emerging markets issue. A report published by IOSCO through the Sustainable Finance Network identified the multiplicity of sustainability frameworks and standards, greenwashing and challenges to investor protection as problems. There is an urgent need to improve the consistency, comparability, reliability and auditability of sustainability reporting.

7.3 Looking beyond what is material to a particular company, through a double materiality lens, is very foreign to the US disclosure regime

An official explained that the US materiality framework encompasses much of the sustainability factors under discussion only when they are material to the long-term financial value of the company. The US disclosure regime is a materiality based, principles-based regime and accommodates many different companies and industries.

7.4 Achieving global consistency with respect to ESG reporting will be as difficult as it is for financial accounting

An official stated that objective financial accounting standards are a key part of the disclosure regime. These change as companies and technology change. Achieving global consistency with respect to financial accounting is difficult and doing the same for ESG will be hard. Focus should instead be on ensuring quality of disclosure.

8. Policy making: ways forward

8.1 Against a plethora of initiatives, many propose the IFRS to be instrumental in fostering consistency and convergence

An official stated that baseline standards that can be applied internationally are needed. The International Financial Reporting Standards (IFRS) Foundation is the custodian of international financial reporting standards. The UK Treasury is very supportive of the International Regulatory Strategy Group's (IRSG) work. Political support and technical input from jurisdictions will be necessary to support the work of the IFRS.

An official stated that global standards need to be strong on governance. IOSCO supports establishing the sustainability standards board under the IFRS Foundation, given the governance there. IOSCO will endorse those standards once they are reviewed and found fit for purpose.

8.2 The challenge will be to leverage the work already done by multiple initiatives and to avoid competing on policy making

An official noted that much work is being done by the voluntary standard setters and the alliance of standard setters, building on the TCFD recommendations. In that context, technical work is already being done by the IFRS Foundation and IOSCO. The approach considers climate first with other issues not too far behind. Continued engagement and governance through the monitoring board is needed, also the recognising of the role of the European Commission.

An official commented that the EU has a longstanding commitment to promoting and developing effective international standards and is in a unique position to integrate common baseline international reporting standards and to be at the vanguard of leadership on the issue globally.

An industry representative stated that the solution should be collaborative, not competitive. A minimum set of standards should include clear, globally comparable definitions.

An industry representative commented that the current situation is challenging, and small steps should be taken initially. Collaboration is necessary for global markets to function well.

An official noted that there is value in homogeneity, but there are also costs to homogeneity, such as undermining the existing framework.

8.3 Achieving flexibility will be key

An official commented that the IFRS's approach will be delivered through building blocks, enabling individual jurisdictions and regions to supplement those baselines.

An official agreed that the building blocks approach is important. More is probably made of double materiality and single materiality than necessary. A European Financial Reporting Advisory Group (EFRAG) report discussed dynamic materiality and how the superset of sustainability topics would eventually become part of enterprise value creation.

An industry representative commented that dynamic materiality can help bridge the gap between pure financial materiality and double materiality. What is material to investors is changing.

An industry representative commented that the high bar already present for financial services reporting should be used to ensure that data provided is relevant. The more detailed and less flexible the rules are, the less likely global collaboration is.

8.4 The EU will go ahead favouring coordination and consistency with different standards and initiatives

A policymaker stated that global markets require global responses. European standards will build on the work that has been done already, aiming for the highest possible level of coordination, consistency, quality and even complementarity with the different standards. Slight adjustments for different markets and business models might be needed. Global coordination and the work that has been done by IOSCO, the IFRS Foundation, the Financial Stability Board (FSB) and G20 is important.