DIVERGENCE OF ESG APPROACHES AT THE GLOBAL LEVEL: WHAT IMPACTS?

1. ESG challenges for the financial sector are being addressed but concern remains

1.1 ESG considerations are now mainstream for financial markets

A public sector representative stated that environmental, social and governance (ESG) is becoming increasingly mainstream. Differing approaches across the world mainly reflect different starting points.

An industry speaker stated that ESG and climate change considerations are a routine part of any Moody's discussions. Almost every time, there is a dialogue around ESG considerations for a particular issue or market. Although some debate whether there is too much emphasis on ESG or climate change, this is as important a consideration for many investors as looking at banks' asset quality, insurers' underwriting capability or their capitalisation.

1.2 Greenwashing, capital misallocation and insufficient financing available are the three issues for which the financial sector is central

A public sector speaker stated that there are three big public policy problems: the potentially serious misallocation of capital without clear disclosures in the context of known science; the problem of greenwashing; and the fundamental public policy issue that any credible scenario in which climate catastrophe is avoided features private markets and private capital playing a central role in channelling trillions of dollars' worth of investment. The financial sector is central to all of those questions.

An industry speaker stated that the point around greenwashing is critical because everyone in both the private and public sectors really wants to avoid it.

1.3 Challenges to address in order to reduce the greenwashing concern

A regulator stated that the rules regarding selling financial products to investors can be made extremely complex, but it is also possible to get a long way at a relatively simple level. Asking where people want to invest, why, and whether they are investing in something that is focused on activities that are indubitably at the green end of the taxonomy is very important. Institutions or projects should not sell brown as green.

Another problem with labelling is that trying to simplify everything down to one indicator might overdo or underestimate the number of dimensions that exist, but intelligent labelling can achieve this.

2. The observed speed of climate risk raising requires being pragmatic by focusing on delivering equivalent/interoperable sustainability labelling and reporting outcomes globally, and agreeing on common principles

An industry speaker reported that 81% of senior executives stated that standardisation of measurement and reporting standards would help to accelerate their net zero efforts. Convergence and standardisation are the ideal outcomes. Their institution is very supportive of the concept of double materiality while recognising that financial materiality will probably take some more time.

Convergence is the tip of the iceberg, which is a rapidly melting one. Without real progress, the world is probably on track for a 1% drop in emissions by 2030 versus the necessary 45% drop. Once there is some agreement on the approach of materiality, there will be issues around implementation, data identification and collection. It will be necessary to decide on how these have to be inputted, the computing, the outcomes that will need to be measured and how this will be adopted. This will be subject to various public and private reporting frameworks, and the necessary APIs and data repositories to collect this information.

This could take decades and, unfortunately, time is not on our side.

The aforementioned also does not mention convergence in other areas of ESG outside of measuring climate risk. Policy and regulation are critical enablers to scaling finance to make these outcomes happen. The focus should shift more to practical outcomes and interoperable regulatory standards that can be achieved in a much shorter timeframe.

An industry speaker stated that Moody's recognises that most of the proposals are currently around principles. There will be more harmonisation of data and metrics over time.

A public sector speaker stated that standards are necessary. There is a balance of arguments, but climate change has created an imperative for action at pace. However, a coherent international standard is necessary.

An industry speaker stated that there is also optimism around agreement on some of the ESG principles. The sustainable finance taxonomy is a very solid piece of work with very strong definitions. There is a risk that what is sustainable within the European context makes a huge amount of sense, but would not necessarily if taken word for word and applied to a country like Bangladesh. It is necessary to untangle the issue around the areas of common agreement on what would work in both markets and strive for interoperable frameworks, rather than attempt harmonisation.

A public sector representative suggested focusing on coalescence around intelligence, ideas, and interoperability because full convergence will not realistically be reached. It is advisable to focus attention on minimising this divergence before managing what is left in a way that allows the financial sector the best chance of delivering on its own net zero requirements.

3. ESG criteria heterogeneity is the only aspect of the existing data and disclosure divergence issue financial markets must deal with

An industry speaker stated that Moody's relies heavily on the skills and experience of its analysts, but it uses a lot of data from a wide variety of sources. When Moody's considers data and disclosures, it notes that it already lives in an imperfect world. It already deals with wide varieties of data and a lack of consistency in data and disclosures in its analysis. Moody's is developing an approach to allow for a lack of consistency.

4. The benefits expected from further convergence, lead to supporting initiatives such as those put forward by the TCFD and the IFRS Standards Board

An industry speaker stated that Moody's is also very supportive of the consistency and harmonisation approaches that have been put forwards by groups like the Task Force on Climate Related Financial Disclosures (TCFD) and the International Financial Reporting Standards (IFRS) Sustainability Standards Board's proposals. Having more standardised disclosures will reduce the complexity of analysis that an investor, credit analyst, or equity analyst needs to go through. The second benefit of more harmonisation is around the cost involved. A more harmonised, standardised approach to disclosure will also make it easier for firms to disclose how they are progressing towards their carbon targets. In addition, it will be much easier for investors to judge who is performing well.

An industry speaker stated that the broad answer is speed of progress. Insofar as it is possible to have more consistency, it is possible to move faster to solve this issue. A financial institution can harness capital and bring global players and standards to the table because it operates globally.

Bank of America is not necessarily waiting for the public sector, although several private sector initiatives are happening. One of those might achieve momentum and become the dominant one until something else comes along. This will happen until or unless regulators produce something. Non governmental organisations (NGOs), journalists and public bodies will want this; asset managers and investors will look for it.

A regulator stated that there are various ways of looking at the situation, but it is not as bad as it is feared to be. TCFD is one of the more global pieces of standard setting of recent years in the financial domain. It originated when not everyone saw the problem as urgent. The basis can be built on for a 'TCFD Plus' that moves away from principles and description to data and definitions. A competition between different approaches, models, and thought processes could lead to a richer way forward.

A regulator stated that he is sceptical about waiting for perfection. There is a broad consensus that it is necessary to start moving fast. The financial risk management problems are especially complex.

A public sector speaker stated that TCFD is an architecture, but it does not deliver the necessary underlying standards. The IFRS is the appropriate forum to take this forward in its new proposed International Sustainability Standards Board.

The other aspects of ESG are important, but climate is the focus. The second step is as much of the global financial system as possible engaging with the IFRS and the International Sustainability Standards Board (ISSB) to take the second step before considering jurisdictional adoption and implementation.

An industry speaker stated that Japan has adopted TCFD, so it covers single materiality. However, the Japanese Financial Services Agency's (JFSA) reaction to examples of disclosures for financial institutions and other general corporates was very helpful. It also supports some of the private sector's activities. More of a dialogue between the public sector and the private sector could be necessary to accelerate private companies' activities.

An industry speaker echoed Bernard Mensah's point that a great deal of activity is happening in the private sector. One example is the work of the Taskforce on Scaling Voluntary Carbon Markets on scaling robust and liquid voluntary carbon markets. Allowing the markets to innovate and try to create new products to move capital is important.

A regulator stated that coalescing around the intelligent types of definitions that emerge is how this will inevitably move forward. If this is not moving fast enough, the public sector can push. If it is going 'completely wild', the public sector can try to channel it.

5. A dynamic materiality approach consisting of a progressive shift from the simple materiality approach toward the much needed double materiality should help to address part of the related complexity

An industry speaker stated that the first part of MUFG's carbon neutral declaration from May 2021 is the bank's aim for net zero emissions in its own operations by 2030. The second is net zero emissions in its entire financing portfolio by 2050. Ambitions around the first target by 2030 are single materiality ones. One challenge centres on MUFG's operation including four partner banks across the Asia area. In these countries and industries, the policies around climate change are very diverse. The key part of engaging with those countries could be consistent disclosures.

The 2050 target is a double materiality matter. The bank has started assessing its targets and action plan. Through such processes, the bank intends to set its interim target by 2030. The nature of the banking activities is a matter of double materiality.

The bank could be a producer as well as a user of disclosure data and information. It should utilise two buckets of its disclosures effectively: enterprise value reporting and sustainability reporting. This is the concept of dynamic materiality. The EU is the global leader in seeking consistent disclosures and methodologies; it also advocates double materiality.

5.1 Non financial disclosures should be consistent with the role assigned to the financial sector regarding sustainability transition of economies

A public sector speaker stated that double materiality is incredibly important for its impact on the environment. It is not possible to have an effective mechanism for directing the investment needed to fund transition if no data or information in the system articulates firms' impact on what there is an attempt to solve. This will be challenging. On the balance of the risks, it is important to move quickly on single materiality.

5.2 Convergence also expresses a need for further regulatory certainty regarding ESG targets

A regulator stated that many are trying to approach the issue from different directions, so it is understandable that there is a desire for certainty. However, this could lead to consistent but poor disclosure. As people seek standardisation, they are not just trying to seek convergence around a set of standards that has the most effective group of lobbyists.

A public sector speaker stated that convergence is important, but none of it should stand in the way of domestic initiatives to move forward on this issue.

5.3 Double materiality disclosures may lead financial regulators to state non financial stances on capital allocation, although these are in the exclusive remit of investors and policy makers

A regulator stated that her views could be different from her colleagues at the SEC. The SEC is working on rules along the lines of climate and human capital disclosures, drawing from a request for comment that the acting chair lead put out in spring 2020.

The general way that ESG disclosure is being approached is concerning because the role of financial regulators is sometimes forgotten. It has historically been inappropriate for financial regulators to take merit positions on capital allocation. The SEC's role is to get material information to investors who can then use that information to make decisions about long term capital allocation and the long term financial value of companies.

Double materiality is premised on the notion that financial disclosure should be about more than a company's long term financial value, but it should be about the outward effects of the company. If the SEC took on that kind of task, its job would be boundless, and its disclosures would be endless.

Cross border work is very important. The end objective of a more sustainable global economy with prosperity for all is not served by all of the SEC's international colleagues using a single set of disclosure standards. Doing so runs the risk of directing all capital in the same direction. Adding climate and social crisis prevention to the SEC's mandate will not be any easier.

A regulator stated that the panellists' problems are intertwined ones around climate, environment, and social issues.

A public sector representative agreed with the but stated that regulators are not being asked to allocate capital.

5.4 Financial regulators should remain focused on the financial sector while understanding and managing climate and sustainability related risks

A regulator stated that he had started his approach to the issue by questioning the mandate that supervisors have to oversee aspects beyond financial risk management. He sometimes detects scope creep among supervisory agencies on this topic and others.

There are four types of risks in the context of climate change in the financial industry: physical risks, transition risks, the risk that the market has insufficient information, and the risk of greenwashing.

6. Addressing greenwashing risks requires urgently defining reliable disclosures

A regulator stated that the risks of disclosure and greenwashing are linked. Greenwashing means that a product created to satisfy an apparent demand ends up alienating that demand. It is also widespread. BaFin recently proposed definitions for when a product can call itself sustainable, which have been predictably unpopular. They have also been criticised for going too fast and being inconsistent with other approaches that might come later. However, even if the prefect solution does not exist, it is time to move.

Private sector initiatives are also necessary to address greenwashing, and competing labels and standards may be fruitful

A regulator stated that there are various ways of looking at the problem of inconsistency in global markets. Being global means being multi local, and there is a cost to that.

Competing labels might exist. It is maybe sometimes necessary for them to converge at some point, and some public sector persuasion is necessary if labelling and definitions are to converge.