

CORPORATE SUSTAINABILITY REPORTING CHALLENGES IN THE EU



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ESG Data, a prerequisite for achieving the transition

The European Union has embarked on an ambitious social and environmental agenda for the upcoming decades. On the climate side alone, in order to succeed in containing the temperature rise of the planet below 1.5°C, in accordance with the Paris Agreement, the EU vowed to decreasing its emissions by 55% by 2030 and achieving carbon neutrality by 2050. These public policy objectives require adequate data from the real economy, so as to be able to assess the cost involved, steer the transition and track the progress made. Against this backdrop, the European Commission published on 6 July, 2021 its Strategy for financing the transition to a sustainable economy, which complements and updates the 2018 Action Plan on financing sustainable growth.

As part of this roadmap, the EU has been developing a holistic framework for ESG data, ranging from the establishment of a European green Taxonomy, which provides a clear definition of sustainable economic activities, to introducing some first ESG disclosure requirements for investors and, lately, an overhaul of corporate sustainability reporting, through the ongoing revision of the non-financial reporting directive.

The EU Taxonomy, the metric system for sustainability

In June 2020, the EU adopted the Taxonomy Regulation, an EU-wide classification system for sustainable economic activities. Sustainability is assessed across the economic activities contribution to six environmental objectives, two of them being climate objectives (climate change mitigation, climate change adaptation), while the rest covers water and marine resources, circular economy, pollution and biodiversity. Also, a sustainable economic activity should do no significant harm to any of these objectives - this is the so-called DNSH principle - and meet some minimal social safeguards. Developing such holistic and science-based instrument was made necessary by the complexity and multidimensional nature of environmental challenges.

European sustainability standards will allow to capture the ever-evolving nature of ESG information.

In practical terms, it is a powerful tool to avoid greenwashing: it allows to make sure that resources invested in sustainable financial products truly contribute to financing the transition and, thereby, that promises made to investors are fulfilled. It entails a whole range of disclosure requirements for companies, who will have to report on the alignment of their economic activities on the Taxonomy, as well as for market players, including for the financial products they distribute. From this year 2022, as the Taxonomy enters into application, climate data will start to flow through the investors and corporates ESG disclosures, made mandatory in particular by SFDR and CSRD.

Investors Disclosure, Corporate Sustainability Reporting

In November 2019, the EU adopted the Sustainable Finance Disclosure Regulation, known as “SFDR” or “Disclosure Regulation”. This piece of legislation requires that financial market participants disclose ESG data to investors, both at the entity and financial products levels. The information provided, such as the Principal Adverse Impacts (PAI) for example, will be harmonized through templates proposed by the European Supervisory Agencies and soon to be adopted by the Commission: the so-called Regulatory Technical Standards, which will enter into application on 1 January, 2023. In the meantime, the EU is negotiating the Corporate Sustainability Reporting Directive (CSRD), which aims to provide a clear and renewed framework for sustainability reporting published by corporates. Companies in the scope of the directive, which should be extended from the 2014 framework under NFRD, will publish sustainability information annually, in line with EU sustainability standards, so as to harmonize ESG data and improve their quality.

The reporting will cover the full spectrum of ESG factors and comply with the principle of double materiality, whereby the company must take into consideration not only the financial materiality but also the impact of its activities on the environment and society. The audit of these reporting will be made mandatory, a key step to ensure the reliability of ESG data. Last, alongside the European Single Access Point (ESAP) project, CSRD aims to make ESG data digital, and easily - and freely for the vast bulk - accessible through a common public database.

Next steps and challenges

European sustainability standards will allow to capture the complexity and ever-evolving nature of ESG information, through a dynamic process of standard-setting by the EFRAG, involving wide consultation of stakeholders and taking into consideration the sectoral dimension of companies. Global convergence of standards will be sought through active collaboration between the EFRAG and other initiatives, including the International Sustainability Standards Board (ISSB) recently established by the IFRS Foundation.



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Accelerating towards net-zero – supporting the economy in the climate transition

In the coming years, greening our economies is one of the greatest challenges we face. To address it, a substantial amount of capital is required to finance the journey to net zero by 2050, and there remains significant progress to be made. FTSE Russell research shows that only around 7% of the global equity market can be considered green based on its Green Revenues model.

The economy will not change overnight. But we need to fast track the transition if we are to meet the Paris Agreement objectives.

Sustainability-related information on business activities is still in short supply and difficult to compare. No common definitions currently exist for most environmental and social data points, and a lack of common reporting frameworks further complicates analysis of performance in these dimensions. Consequently, methodologies used by banks and investors to allocate capital

in line with sustainability targets often rely on arbitrary methodological choices and assumptions.

Tackling these issues requires swift action. Businesses need to go further and faster in developing and disclosing credible frameworks for managing climate-related risks and opportunities. That is why, in October, LSEG published climate reporting guidance to support our issuers in implementing the recommendations of the Taskforce on Climate-related Financial Disclosures (TCFD).

To be of greatest value to investors disclosures should include transition plans. The latest TCFD recommendations offer guidance in this area including FTSE Russell's research on investor-oriented carbon targets. Initiatives such as the TPI Global Climate Transition Centre to be launched this year will provide free and publicly available data on 10,000 companies' transition preparedness – can help investors with their assessments.

We also need to enhance understanding among companies as to how their sustainability practices and performance flow through to investment strategies or indexes. Transparent methodologies and initiatives like Climate Action 100+, which enable engagement between investors and companies, help to inform business leaders on the impact of sustainability performance on their cost of capital, and in turn incentivise alignment with sustainability objectives.

To be of greatest value to investors disclosures should include transition plans.

While the private sector has an important role to play in driving disclosure, governments need to develop sustainable finance policy frameworks at pace. Businesses should be required to make high quality sustainability-related disclosures on a mandatory basis. The EU is leading in this regard with its Corporate Sustainability Reporting Directive (CSRD), which will oblige 50,000 European companies to report on the integration of sustainability into their strategy, business models and governance from 2024.

Financial markets rely on a common language, and international coordina-

tion on sustainability reporting will be crucial. The global baseline reporting standards being developed by the International Sustainability Standards Board (ISSB) will make it much easier for companies to make meaningful disclosures, and for investors to conduct accurate assessments of their sustainability performance.

Beyond establishing relevant indicators, the ISSB should set out a clear definition of materiality to guide issuers in reporting relevant, industry-specific information. While some would suggest only tracking sustainability issues that are financially material to a company, under the notion of “double materiality”, the EU argues we should also consider companies' impacts on society and the environment. These two perspectives are reconcilable as the difference between financial and double materiality is often just about time horizons. What is material for society and the environment ultimately becomes financially material for the company in the long term.

The UK has already announced its intention to incorporate the ISSB standards into its upcoming Sustainability Disclosure Requirements – an approach that should ideally be adopted on a global basis. Divergent disclosure rules would create market fragmentation, impede cross-border capital flows and increase compliance costs for companies operating worldwide. The same logic applies when it comes to green taxonomies and, accordingly, the common-ground taxonomy work of the International Platform of Sustainable Finance is highly important. Although it may be a challenge to obtain perfect alignment between taxonomies, defining global high-level guiding principles drawing on the experience of the EU Taxonomy, and common environmental performance indicators for all taxonomies would be a solid foundation.

2022 is thus a milestone year for improving sustainability reporting. The shaping of reporting standards and the interoperability of taxonomies are crucial to obtain relevant data from businesses and efficiently support the transition to a sustainable global economy.



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Challenges around ideal ESG data sets and their importance in assessments

To make informed decisions on Environment, Social and Governance (ESG) related questions, financial market participants require a holistic understanding of corporate non-financial risk management and its real-world impact, including current, backward and forward-looking information and data. While ESG research providers have been producing data and analysis for almost three decades, there is a growing need for increasingly sophisticated and granular data in the responsible investment and sustainable finance community in light of complex and expanding set of topics and angles to cover, in addition to new regulatory demands.

There are several obstacles to overcome and some principles to follow in order to produce high-quality ESG data.

Standardized reporting: The more standardized corporate sustainability reporting is, the easier it is to build coherent and comparable sets of data. Much progress has been made on building a reporting ecosystem that reflects ESG risks and impacts - from the

Global Reporting Initiative, that now underpins European standard setting, to the Sustainability Accounting Standards Board and the International Integrated Reporting Council, now part of the IFRS Foundation's International Sustainability Standards Board. While these efforts are essential in creating a consistent and reliable foundation for ESG disclosure, they are still nascent and will need to grow into more coherent frameworks to facilitate the aggregation of data. It may also take a number of years before this foundational layer of disclosures across all ESG criteria are widely adopted, even as new disclosure standards are already pushing more and more companies to report, most notably in the EU through the Corporate Sustainability Reporting Directive (CSRD), but also increasingly across the world.

Data gaps: In addition to varying from one company to the other and using different calculations, corporate sustainability reporting is not a reality in all companies, especially in emerging economies and within smaller firms. In order to construct coherent ESG datasets, research providers thus face the challenge of how to fill gaps when companies don't disclose. One option is to leave gaps open and to attribute poor scores for non-disclosure. While this is an option for ESG scoring models, it doesn't help when looking to build coherent "raw data" sets. A second option is to use modelled data and advanced analytics, which however only produces reliable results if models use real world data on a given company (geographical location, size of company, etc.) and don't simply apply sector averages.

**There is a growing
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How to look into the future?

There are two ways to forecast a company's future ESG performance. The first is quantitative: basing analysis on past evolution data, for example, when using climate scenarios. The second is through examining policies (human rights, supply chain risk management, etc), which can help to predict the extent to which a company may reduce its future negative impacts. ESG data also requires context. Narrative reporting analysis has always been a key component of a complete ESG assessment that complements

metrics and targets data. For example, expertise lies not merely in confirming whether a policy is in place, but also whether a policy has been implemented effectively.

Up to date assessment also needs to go further than looking into how a company manages its ESG risks through policies and implementation measures. Comprehensive ESG Assessments should also assess actual behaviours and incorporate controversies risk assessment data as they happen, providing a real-time adjustment to ESG scores.

In addition to analysing the basic sustainability framework and cross-sector ESG topics such as GHG emissions, percentage of women on board, human rights policies, etc., the thorough ESG analysis of a company must take into account sector specificities. E.g. What is the percentage of low-emission vehicles in the overall product portfolio of a car producer? How does an agribusiness / food company manage the use of pesticides? How does a textile & apparel company manage human rights or labour rights aspects in its supply chain?

In sum, while much progress has been made, the ESG data landscape is still evolving. Demands for greater usefulness of ESG data will prompt further scrutiny into disclosed information and encourage more innovation to help answer questions that stakeholders are seeking to answer.



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Do or die: sustainability reporting urgently requires alignment & prioritization

Challenges like climate change, pandemics and cyber risk represent major structural changes for economies and firms alike. They are inherently global in nature and thus require international coordination and global solutions, including associated policy and regulatory architecture. However, policy frameworks were rather developed in parallel in recent years with a significant increase in the scope and volume of regulatory instruments being announced and implemented – especially in the area of sustainable finance.

The financial sector plays a crucial role in facilitating the economic transition towards a low-carbon, sustainable future. Yet, to fulfil this role, the availability, high quality and comparability of sustainability data is essential. Currently, users of sustainability data all over the world are struggling with a plethora of (upcoming) sustainability reporting frameworks and standards that do not enable comparable disclosures.

The standardization that has already taken place in financial reporting offers a blueprint for success. Therefore, the launch of the International Sustainability Standards Board (ISSB) and announced establishment of a “global baseline” for sustainability reporting is a critical milestone in the process to consolidate frameworks while building upon existing and proven standards (e.g. the recommendations of the FSB Task Force on Climate-Related Financial Disclosures (TCFD)). However, the journey towards common climate and broader sustainability disclosures is at an early stage and individual jurisdictional approaches developed in parallel to global standards generate transitional challenges.

In this context, we highly appreciate the EU Corporate Sustainability Reporting Directive (CSRD) to achieve fast progress on reporting while supporting ambitious wider policy priorities of the EU. The Directive will allow to streamline sustainability disclosure legislation at EU level, enable financial market participants to make better and more sustainable investment decisions and address data needs for other reporting requirements (e.g. EU Taxonomy Regulation, Sustainable Finance Disclosure Regulation (SFDR)). It is clear that the EU cannot wait for ultimate global standards considering the urgent need for action and the near-term application of several EU sustainable finance regulations.

It is of utmost importance that the EU engages closely with the ISSB.

However, it is of utmost importance that the EU engages closely with the ISSB to ensure full alignment and interoperability of the EU sustainability reporting framework with the ISSB’s global baseline. In order to facilitate a co-construction process, it is essential to start with a climate-focused, prioritized set of standards while other sustainability topics, including with view to any upcoming ESG challenges, are tackled step-by-step over the next years. Jurisdictional add-ons to meet regional specifics should only be included (as relevant) after final alignment on the global baseline.

However, a prevailing challenge remains that the integration of sustainability into business operations

of financial service providers (including risk management, transition plans, transparency, products) is required much earlier than the expected arrival of relevant corporate sustainability data. In order to bridge the gap, it is necessary to develop uniform approaches for proxying key variables, which are feasible to produce and accepted by supervisors.

The vision of globally aligned frameworks for sustainable finance is based on the common goal to mitigate global sustainability challenges while ensuring market integrity, efficiency and resilience for the benefit of market participants, the environment and ultimately society as a whole. In contrast, a permanent divergence of sustainable finance policy frameworks and reporting requirements creates an unlevel playing field. This would result in challenging implementation, coordination and prioritization issues for financial market participants, the real economy and regulators as well as a heightened risk of greenwashing and confusion for consumers. It could ultimately constrain efforts to scale up capital needed for a successful transition to a net-zero future – a price which the world cannot afford to pay.

We therefore need to ensure integrity in sustainable finance markets from a global perspective – this requires strong foundations, including high-quality, verifiable, and comparable global sustainability data – and the opportunity to act is now.



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Seizing the net zero opportunity for financial services

It is abundantly clear that climate change is not only a scientific challenge, but also an economic one. Just as scientists have long warned of the catastrophic physical effects of rising global temperatures,¹ economists are sounding the alarm bells.

The risk is existential, but there is also opportunity. Recent analysis has demonstrated that the transition to net zero emissions could drive as much as 25 percent higher cumulative GDP growth over the next two decades alone,² turning this existential risk into an enormous commercial opportunity. The European Central Bank's economy-wide stress test also underlined that firms benefit from adopting green policies earlier rather than later.³

The question is how the financial sector will navigate and enable the transition.

The transition begins with disclosure. Without a view on how companies are managing climate change effects or portfolio net zero alignment, capital markets cannot accurately price the

financial impacts of a warming planet. Investor demand for consistent, comparable, and reliable data is rapidly growing, but there are still challenges to accessing quality data.

The Task Force on Climate-related Financial Disclosures (TCFD) was born as a solution to this problem. Established in 2015 by the G20's Financial Stability Board, the TCFD created recommendations for climate-related financial disclosures to promote more informed investing, lending, and insurance underwriting decisions. In 2017, the Task Force published voluntary disclosure recommendations and guidance focused on four thematic areas: governance, strategy, risk management, and metrics and targets.

Support for the TCFD framework has grown rapidly, reflecting a desire to improve the quality and quantity of reported data in the market. More than 3,000 organizations representing a market capitalization of \$28 trillion now support the TCFD recommendations. The G7 and G20 have endorsed the framework along with more than 110 regulators and government entities. At COP26, the International Financial Reporting Standards Foundation formed the International Sustainability Standards Board which will develop a global sustainability reporting standard based on the TCFD framework.

Climate change represents both risk and reward for the financial sector.

Europe has consistently led progress on improving disclosure: the EU was the first major region to introduce mandatory climate disclosure. Both the European Commission and European Financial Reporting Advisory Group are building upon the TCFD recommendations to create a unified set of mandatory sustainability reporting standards through the new Corporate Sustainability Reporting Directive's framework. These standards will be critical to helping investors assess climate and sustainability risks and opportunities, which in turn will direct capital towards long-term sustainable projects.

If we are to achieve the systemic change required, we also need coordinated action across the global financial system so that every financial decision takes climate into account. Governments and regulators need to work together

to ensure standards are derived from common baseline metrics and inputs from market participants.

The Glasgow Financial Alliance for Net Zero (GFANZ) was launched to coordinate and raise the financial sector's ambition on climate change. The alliance unites all sectors of the private financial system, covering banks, insurers, asset owners, asset managers, and service providers into one coalition. Today, over 450 financial institutions from 45 countries – across Europe, Latin America, and Asia – and representing over \$130tn in assets, are members of GFANZ. GFANZ members must adhere to the UN Race to Zero's criteria for inclusion, which means they have committed to using science-based guidelines to reach net-zero emissions by 2050 and have set 2030 interim targets that represent a fair share of the 50% decarbonization required by the end of the decade. Further, they must publish a net-zero transition strategy and commit to transparent reporting and accounting on progress against those targets.

This global initiative will drive much-needed consistency, science-based rigor, and public accountability in how financial institutions determine, disclose, and achieve progress against net zero targets. Together, GFANZ financial institutions are working with their clients to channel investment to green solutions, reduce emissions, and drive economic growth.

COP26 was a significant turning point as the private sector demonstrated their willingness to play a key role in fighting climate change. High-quality disclosures and credible net zero targets are key mechanisms to mobilizing private sector investment for sustainability. Ahead of COP27, and to meet the pace and urgency of the financial crisis, financial institutions and governments alike must deliver on their commitments. There is a tremendous opportunity to act in a way that benefits both business and our planet, and the financial sector in partnership with government is a catalyst to seizing the net zero opportunity.

1. https://www.ipcc.ch/site/assets/uploads/sites/2/2019/06/SR15_Full_Report_Low_Res.pdf (pg. 10, 12)
2. https://www.moody.com/sites/products/ProductAttachments/Moodys_ReadyOrNot.pdf (pg. 2)
3. <https://www.ecb.europa.eu/press/pr/date/2021/html/ecb.pr210922~59ade4710b.en.html>



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The challenges of reliable and comparable Corporate Sustainability Reporting

According to the proposed Corporate Sustainability Reporting Directive (CSRD) currently under legislative discussion, EU companies with more than 250 employees, listed companies (except listed micro-companies), and companies meeting the CSRD's turnover or balance sheet thresholds will have to integrate sustainability disclosures into the management report. This new corporate reporting dimension will include ESG data into investors' decision-making frameworks and boost the coverage of sustainability indicators across the Union.

A key feature of this new reporting framework is the concept of double materiality that obliges companies to measure both the impact of sustainability topics on the company itself as well as their impact on the environment, society, and the economy. This information will form part of an integrated set of information to provide users of that information with an overall understanding of the performance, the development, and the impact of

the company. In other words, to be meaningful, sustainability and financial information cannot be prepared into two parallel silos. Consistency of financial and sustainability information is a precondition for added value sustainability reporting. Such Integrated Reporting will bring together material information reflecting the commercial, financial, social, and environmental context within which the company operates.

The immediate practical challenge for companies will be to define, collect, process, and ensure the quality of the relevant information. Data availability, quality and comparability will then be essential. The CSRD will translate into EU standards that will help harmonizing transparency around data acquisition, materiality, aggregation, and metric weighting.

Once presented in accordance with the forthcoming sustainability reporting standards, information should be reliable and comparable. For that purpose, the CSRD, introduces the concept of assurance over sustainability reporting. The objective is also to prevent sustainability reporting from green or rainbow-washing suspicion.

**Reliable and comparable
sustainability
information needs
independent and high-
quality assurance.**

While there is a need to start as soon as possible, there is also a need to ensure an efficient and comprehensive sustainability reporting framework. To favor effective compliance with the new requirements, the CSRD proposes a twostep approach. In the initial phase, company's sustainability information will be subjected to 'limited assurance' by which the assurance service provider reduces the risk of material misstatement to an acceptably low level. With such level of assurance, the service provider's primary focus is to understand the process used to compile the reported information (enquiry, observation, and analytical procedures) and reach a negative opinion by which nothing has come to suggest that the information provided is materially misstated. Several years after the entry into force of the CSRD, sustainability information will be subjected to 'reasonable assurance' by which the assurance service provider obtains sufficient appropriate evidence that the

information provided is not materially misstated. The work effort with such level of assurance entails more extensive procedures than in a 'limited assurance' engagement. They include: (i) risk identification and assessment that any matters may not be presented fairly; (ii) testing the operating effectiveness of the company's internal controls; and (ii) substantive procedures. The result is the expression of a conclusion in a positive form.

Such assurance will be carried out by the statutory auditor(s) or audit firm(s) to help ensure the connectivity between the financial and sustainability information. However, the CSRD will also open the possibility for Member States to allow independent assurance service providers to provide a conclusion on sustainability information. To avoid sustainability assurance quality differences, independent assurance services providers will need to be accredited under the same conditions than auditor(s) or audit firm(s).

Time pressure will nevertheless most likely lead companies to request such sustainability assurance from their existing statutory auditor(s) or audit firm(s). The result is that this new integrated reporting market, embracing both financial and sustainability reporting, risks replicating the long-lasting audit market concentration evidenced in the last Audit Market Monitoring Report of the European Commission (COM (2021) 29 - January 28, 2021). This makes all the more relevant the initiative by the Commission to revisit the Audit Directive and Regulation, to create a more vibrant and diverse EU audit and assurance market.