Corporate Sustainability Reporting: data challenges

1. The Corporate Sustainability Reporting Directive (CSRD): a step forward to a precise and strong legislative framework

A Central Bank official noted that since 2015 French financial institutions, banks and insurers have had to carry out sustainability reporting under article 173 of the French Energy Transition for Green Growth Act.

A regulator described how the CSRD will create a strong legislative level with several key features. First, there is the establishment of a mandatory regime for all large entities, listed or not. In the EU, one definition of 'large entities' is entities with over 250 employees, which illustrates how many businesses will be in scope. Small and medium sized enterprises (SME) will be encouraged to report under a voluntary regime. Secondly, there will be a comprehensive set of standards not only at the legislative level but at the regulatory level as well, which will cover environmental, social and governance (ESG). Thirdly, CSRD contains a clear commitment to fundamental concepts such as double materiality and the principles of information quality from financial reporting: relevance, faithful representation, understandability, verifiability, and comparability. Finally, auditing will be a mandatory element of sustainability reporting. On that basis, level 1 will be quite strong, but it will be important to see the features of the regulatory level.

The regulator explained that this sits under a clear architecture with what the European Financial Reporting Advisory Group (EFRAG) calls the 'rule of three'. The first part of this rule of three is around the three layers of sector agnostic, sector specific and entity specific disclosures. The second element is the reporting areas: strategy, governance, and risk management; implementation, i.e., being pragmatic and realistic about what entities produce; and measurement of performance. Thirdly and finally, there are also three topics: E, S and G. These features provide reasonable assurance that progress is being made in the right direction. There is a good case to be optimistic about this topic. The EU is making progress on the quality of its sustainability reporting. In fact, CSRD will be a game changing step.

An industry representative agreed that the framework coming from the CSRD and the standards under development at EFRAG are moving in the right direction. Another industry speaker agreed that the CSRD is a major step forward. London Stock Exchange Group (LSEG) is very supportive of the disclosure requirements, and the European Union is showing strong leadership here. Hopefully, other countries' financial sectors and private firms will develop similar efforts around alignment. From the investor perspective, the CSRD will help investors meet their new Sustainable Finance Disclosure Regulation (SFDR) and taxonomy requirements.

2. The key role of ESG data providers in sharing and distributing data between companies and financial institutions

An industry representative described the role of ESG data providers, which are institutions that sit between the corporates that disclose information and the investors and financial institutions that need it to make investment, financing, or other decisions. The industry representative noted that there are three types of information that will be required, adding that it would be 'wonderful' if EFRAG could take these issues forward in their work.

First, there is a need for quantitative information, i.e., fundamental information on ESG issues such as gender equality, greenhouse gas emissions and so on. This is the basic information needed from corporates. The industry is moving in the right direction, although there are many different standards. CSRD will help, but it will take time and it is a particular issue for smaller companies. Secondly, there is a need for qualitative information. This is required by ESG research providers and ESG data providers, who analyse what is happening inside a company and who must take a position on the ESG performance of companies. In this sense, 'qualitative information' means information on the policies that a corporate puts in place, such as human rights policies or labour policies in a particular jurisdiction. It is also important for ESG data providers to have access to information and policies such as codes of conduct. These should be made publicly available on firms' websites. The third type of data that is needed is somewhat trickier and quite new for ESG: business information. Increasingly, data providers encounter challenges in learning how a company performs on biodiversity, for example, or what kind of physical risks a company faces from climate change. Data providers need locations data from companies, e.g. data on where factories or sites are based. There is also a need for sector information and data on the type and quantity of products that a company produces. This is an increasingly frequent requirement, which is extremely important for impact analysis.

The industry representative also highlighted the importance of forward looking data. There are two ways to find out what might happen in the future. The first way is to create models based on past performance, but this requires good historical data on how a company has performed, which is not always available. The second is to do qualitative analysis. This looks at how a company is positioned in terms of policies and the kinds of measures it puts in place to ensure those policies are implemented. For ESG data providers, this is a way to look into the future by understanding how prepared a company is to respond to ESG challenges.

An industry speaker emphasised the role of ESG scores or ratings. These tools are being used increasingly in decision making processes. This can be seen in investment decision making, business decision making, capital raising decisions, on the passive and active sides of asset management and in public markets and private markets. These scores are being used everywhere.

3. A new pillar to financial reporting: sustainability and climate related reporting

A regulator noted that EFRAG is modifying its governance by creating a sustainability reporting pillar in addition to its financial reporting pillar.

A Central Bank official explained that financial institutions are familiar with producing financial information and reporting organised information. The Banque de France considers that five ingredients will be required to provide meaningful and usable climate related reporting. First, there is a requirement around data availability. Secondly, definitions and methodologies must use the same vocabulary. Data is not enough; financial institutions should have the same vocabulary and the same understanding of what is reported. A taxonomy could provide this framework; it is vital to get into the detail of this and to share definitions and understanding. Thirdly, there is a need for standardisation and common formats, which will make data comparable and achieve greater transparency. Fourthly, there is a requirement for easy and complete access to data and reporting. Finally, there is a need for reliable information. CSRD will be a substantial benefit because it will require reported information to be audited. Even if this is resource intensive, it is necessary to engender trust in the data that is produced.

An industry speaker suggested that the incorporation of sustainability considerations into financial processes is accelerating incredibly quickly. There is a huge and growing demand for help around incorporating data and understanding how it impacts decision-making and process innovation.

An industry representative considered that auditors have an important role to play not only in terms of supporting pragmatic solutions in the initial years of reporting but also in relation to the connectivity between financial reporting and sustainability reporting. Indeed, it is sensible for the same auditors to assess the financial and sustainability figures and take an integrated view of a company. In the long run, a complete disconnect between the two frameworks does not make sense.

A regulator emphasised the collective nature of the effort on sustainability reporting. If the financial sector is serious about putting sustainability reporting on an equal footing with financial reporting, there will have to be a chain of responsibilities. A chain is only as strong as its weakest link, and the financial sector should not have any weak links.

4. Several challenges remain

4.1 Data availability, consistency and quality need to be improved

A Central Bank official outlined the difficulties around data availability and comparability that emerged during the first climate pilot exercise conducted by the Autorité de Contrôle Prudentiel et de Resolution (ACPR) in 2020. Some of the information received was absent or incomplete, in particular on physical risks and especially at the European level. The ACPR and the Autorité des Marchés Financiers (AMF) also conducted joint work on the commitments made by financial institutions on the greening and decarbonisation of their activities. Again, it was difficult to extract a clear conclusion from this data due to a lack of clarity on definitions. The participants did not use the same vocabulary, which made it difficult to aggregate data or reach conclusions.

An industry speaker highlighted the existence of fragmentation in the data, a lack of high quality data and a lack of transparency in the definitions. These issues are hampering efforts in this space significantly. Individual institutions are solving for small pieces of the puzzle; the sector is not yet solving for the overall puzzle. There should be clear definitions on how data is collected and data points are used. It is 'amazing' to see how complicated sustainability and ESG data is. It has become very important to understand what a specific data point actually measures. Nobody argues about the definition of 'book to market'; many people argue about the definition of 'diversity'. This demonstrates the need for transparency. There is also a broader need for more data across asset classes and markets globally, regionally and in different sectors. This should be tied together by a common language and framework at a global level.

An industry representative suggested that ESG data providers are facing a particular challenge. ESG data is indeed very complex. There are hundreds of single indicators that need to be analysed and that clients ask for. In this regard, it is very challenging to make progress on SMEs who disclose less data and who have less resources to dedicate to ESG reporting. There are two main issues here. First, modelling the data will be extremely important. Many of the players in ESG data are already doing this. However, there should be deeper dives done into some of these models because what the models produce is not necessarily what is expected. There can be a problem with bad data going in and bad data coming out and real-world information on sectors, company size and location should be included. Simply using average scores on an indicator level can lead to false results. Secondly, ESG assessment models (and disclosure obligations) can be simplified for SMEs, using less data points.

A Central Bank official emphasised the importance of transparency and disclosure both from counterparts and corporates. Transition pathways will be an important element of this transparency. It will be necessary to have the right processes and access to use the information, but it will also be important to have visibility on the efforts made by corporates to define pathways and to be able to ascertain whether the vision in those pathways has been implemented.

4.2 The regulatory framework is still under construction and there is a need for a global language

An industry representative considered that the absence of a harmonised regulation and sustainability reporting framework is a key challenge. CSRD is clearly a significant step forward, but it will not come into force for two or three years. This time lag creates a challenge. Financial institutions will have to wait until corporates produce their first reports. As always, there is a one year delay between reporting periods. At the moment, the industry is in an interim stage. This information is available and there are reporting requirements under SFDR, the taxonomy and so on. However, the underlying data are missing to a considerable extent. Nevertheless, this alone will probably be insufficient for financial institutions. For example, Allianz invests customer proceeds globally. There is a need for international alignment on sustainability reporting requirements to foster transparency and comparability globally. This will ensure a level playing field for information preparers, but it is also important for users, because financial institutions need to manage sustainability risk for all investments, not only those in European investees.

A Central Bank official suggested that the CSDR is an important element of the progress that must be made. It will be a very long journey and it is essential to start the journey now.

An industry speaker agreed on the need for the CSDR to be integrated within a common global language. This will enable global portfolios and global investors to look at decision making holistically. It is essential for the industry to provide better clarity on how methodologies work and on the underlying data. The task of the public sector is to set the frameworks and requirements for disclosure, which will create a common language and basis of truth.

An industry representative noted that preparers also do not want a completely fragmented landscape of regulation and metrics. Within the EU there is the taxonomy, the CSRD and several other regulations. These tools and frameworks must be interoperable; this is also true at a global level.

An industry speaker highlighted the challenge for corporates and financial institutions around creating consistent processes to identify data sources and production chains. The CSRD has expanded the scope, depth, quality, and quantity of information on sustainability, but the directive on corporate sustainability due diligence will also soon be announced. The practical implementation of this in data aggregation and compilation, i.e. its transformation into compliant sustainability reporting approved by governance bodies, requires serious work if it is to avoid the quasi duplication of similar information and create standardised processes with multiple purposes. It remains unclear how markets and investors will interpret and use this information. It will take several years before these benchmarks become meaningful reference points. A completely new mindset and skillset is needed here, including for supervisors.

4.3 Finding the right balance: all actors need to define clear strategies to create a roadmap/pathway and provide complete sustainability reporting

An industry representative noted that it is also important for Europe to support global developments. It is impossible to pause things in Europe until a global baseline is established. There is an urgent need for data, but there is also a need to find the right balance between co constructing the global baseline with the International Sustainability Standards Board (ISSB) and the need to make progress in Europe in line with the requirements of European regulation.

An industry speaker outlined two key recommendations. First, it is important to understand that private markets are equally as important as public markets in the transition. Excluding private markets from these efforts, risks missing part of the climate impact. The fact a company is publicly listed or the fact an instrument is public does not determine how relevant it is in the transition. Therefore, greater consideration should be given to the introduction of a strong framework for the private markets. Secondly, transition information should be included in the CSRD requirements. There is a need for information around companies' governance processes and a need for clear targets on greenhouse emissions. Looking forward, targets are a key component that will inform the journey as well as the destination.

An industry speaker noted the challenge around the intertwined nature of financial and sustainability information. To be meaningful, sustainability information and financial information cannot be prepared in two parallel silos. Consistency with financial reporting is a precondition of the added value in sustainability reporting. Such integrated reporting should embrace all aspects of material information, reflecting the commercial, financial, social, and environmental context in which a company operates.

An industry representative emphasised the need for prioritisation on feasibility and proportionality. It is impossible to ask all companies to meet the same level. Prioritisation on scope and timing is also important. The world cannot be saved in a day; progress will be needed over a period of time without delaying the implementation of the CSRD. Another industry speaker agreed on the need for prioritisation. There are many new demands and regulations. Trying to solve everything simultaneously risks a reliance on placeholder solutions that ultimately will not have the required impact.

A Central Bank official suggested that it is important to start with strategy, because the industry needs a forward looking approach. A strategy will facilitate a step by step approach and a roadmap. The most important element here is the transition pathway, and a strategy can be the first step. For example, Banque de France launched a responsible investor strategy. This was a chart which contained the vision and the way to establish the goal. The next objective was to build capacity. Banque de France built capacity and asked for help from service providers. This type of process is also being used for the roadmap for greening monetary policy at the Eurosystem; there was a strong commitment on this from the Governing Council.

4.4 One last challenge: corporates and CEOs should be supported in order to encourage disclosure and involve them seriously in the process

A regulator outlined the key components of the chain of responsibilities around sustainability reporting. First, there is a need for robust standards. This is not something that a CEO can do; it is a task for other people. At the level of the company, there is a need for management processes; the governance must also take this seriously and ensure there is the proper oversight. Then the auditors must also play their role. There is a question around digitisation because it is essential not to lag on this. The process should be digital from the beginning. This implies a need to have the data and the taxonomy in place. Finally, there is a need for an enforcement system that can see that progress is being made in a pragmatic way. These are the six links in the chain; hopefully none of them will be weak.

An official noted that corporates are being asked to provide a substantial amount of data. CEOs might not understand what will be done with this data, but in the end, they understand that their company will be judged, and it will influence the firm's financing. If this is the law, a CEO will do it, but they will want the wider financial industry to help the corporate using reinsurance.

An industry representative conceded that this is a real challenge. Corporates will need a considerable amount of support. All stakeholders involved in sustainability reporting should provide their support, but the public sector has a specific role to play due to the lack of harmonised regulation and the fact that the regulation is evolving. Firstly, prioritisation is important. If a CEO were asked to provide everything in a complete form, very fast and fully assured by external auditors, the disclosure would not happen. Even for larger corporates, which have sometimes been doing sustainability reporting for two decades, the upcoming requirements are a real challenge. There is also a need to have safeguards during the first years of reporting. Companies need to be encouraged to disclose, make progress, and not hold back because they feel uneasy. Public authorities and market participants must work towards pragmatic solutions.

An industry speaker emphasised that helping CEOs would involve action on data and frameworks, but it would also require interpretability. CEOs will need to be provided with the tools to understand what sustainability reporting means for their business and their decision making.