Global convergence of sustainability reporting standards

Introduction

The Chair welcomed panellists to the session on global convergence in sustainability reporting standards. Across many of the discussions about greenwashing, ESG and sustainable asset management, there are common issues such as the access to high quality and credible data and the need for comparable and interoperable disclosure and reporting. In response to concerns about the comparability of ESG disclosures and the quality of climate risk data, standard setters are beginning to turn disclosure guidance into sustainability reporting standards. The central questions are whether the baseline reporting standards are aligned with financial materiality and whether international convergence can be achieved, or rather interoperability will be sufficient. There are different timeframes for implementation, different metrics, and different concepts of materiality. The understandable increase in reporting obligations may well create temporary burdens, such as implementations, from SMEs in Europe to corporations in emerging markets.

1. The progress made by International Sustainability Standard Board (ISSB)

ISSB is finalising its reporting and has made great progress so far. Establishing global baseline standards for sustainability reporting is a major milestone. An official confirmed that ISSB is on track to publish its S1 and S2 standards in June, which will establish a global baseline for disclosures. Primarily, ISSB wants to ensure it provides information that meets investors' information needs. The term 'financial materiality' is often not sufficiently all encompassing. When it comes to investors' information needs, it is important to understand that ISSB requirements will include information on greenhouse gas emissions, for example, because investors need to understand the transition risks produced by those emissions. This is not a question of single materiality; the disclosures include information about the impacts of entities on the environment and society when necessary is to meet investors' information needs. ISSB wants to make sure the information provided enables investors to make global comparisons, looking at global capital markets and the need to make allocation decisions around the world. ISSB's goal is to enable companies to communicate information about sustainability risks and opportunities to investors alongside their financial statements. This type of reporting uses the same filter as a financial statement: it does not include every possible piece of information; it only includes information that is significant to investment decisions. To make this baseline global, ISSB is working hard to ensure the process takes account of global input. ISSB received 1,400 comment letters on its first two exposure drafts, and it has a jurisdictional working group that includes the UK, the US, Europe, Japan, China, and the International Organization of Securities Commissions (IOSCO). As part of this effort, ISSB and partners are working to make sure its baseline is fit for use around the world. IOSCO endorsement of the standards, for example, would signal that they are fit to use as a basis for reporting around the world. Once the standards are finalised, ISSB will ask jurisdictions to adopt them as a global baseline.

Finally, while the role of the IFRS Foundation and the ISSB is to meet investors' information needs, there are other important information needs and other users of information. This is why it is important that the ISSM has taken a building block approach. The global baseline can be used to meet investors' information needs and then incremental disclosures can be added to meet the needs of others. This demonstrates why interoperability is critically important. It will be more efficient if companies report using a global language. If there is a need for incremental disclosures to meet other needs, those can also be included. This illustrates why ISSB's partnership with the Global Reporting Initiative (GRI) is very important. Between ISSB and GRI, a broad range of information can be delivered to meet different information needs.

An industry representative noted that Morgan Stanley has advocated a phased approach, and it is exciting to see that ISSB has built on some of the things Morgan Stanley has already implemented, such as the Task Force on Climate-Related Financial Disclosures (TCFD) report and the Sustainability Accounting Standards Board (SASB) standards. ISSB has indeed used those as building blocks and then added other kinds of innovation, such as the methodology developed by the Partnership for Carbon Accounting Financials (PCAF) to quantify the emissions of finance, which is very material for banks. Ultimately, it is very gratifying to see that ISSB is in touch with the reality of the situation for banks. There are significant issues around data quality, the lag in some of this data and the question of scope three reporting relief for banks. If banks are going to hit their net zero goals, their clients will have to decarbonise. For that reason, the banks must be part of the conversation.

2. The progress made in the European Union

In terms of moving above the baseline, Europe is in the lead. An official described how the European Financial

Reporting Advisory Group (EFRAG) started its journey September 2020 in the context of the European Commission's policies on sustainable development and sustainable finance. In April 2021, the European Commission tabled its proposal for the Corporate Sustainability Reporting Directive (CSRD). EFRAG delivered its technical advice to the European Commission in November 2022 and there are now draft 12 standards. There is one general standard of definitions and critical concepts; one cross cutting standard to ensure there is no repetition regarding the interaction between sustainability matters and the company's governance, strategy, business models and management of impacts risks and opportunities; and 10 topical standards that address the environmental, social or governance matters that are generally considered as key.

This creates a comprehensive system. To develop it, EFRAG used a process involving exposure drafts, public consultation and a streamlining exercise following the consultation. The Commission will now determine how to take action through a delegated act in summer 2023. The goal is critical, but it is also important to bear in mind the need for phasing in and streamlining. To avoid greenwashing, there is a need for real substance that extends beyond a single topic. This can be done on a step by step basis or by starting with comprehensive coverage and then reducing the size of the step on day one and progressively phasing in the implementation. EFRAG is also working to produce precise comparisons to ensure there is interoperability between the most acknowledged sets of standards.

A policymaker emphasised the need for this issue to be discussed regionally and internationally. Climate change is global. It is everyone's problem, and a massive amount of public and private capital must be allocated to the transition and to green and sustainable projects. Many global companies need to be part of the transition. The more consistent, convergent, and interoperable the various frameworks are, the easier it will be to ensure that global firms can do the necessary reporting. This need for international discussion also demonstrates why the European Commission supports the work of ISSB: it is a baseline to build on, while some jurisdiction may wish to go further. Europe has been on this journey for some time already, which means it has a wider scope of its reporting obligations and has already looked at areas beyond climate.

In terms of double materiality or financial materiality, it is important to focus more on the substance of what is being said and less on the words being used. Double materiality is core to the EU's CSRD framework. The European Commission firmly believes in the need to look not only at how companies impact the environment but also at how the environment impacts companies. It is clear that financial materiality and company impact are intertwined. This comes through in some of the standards being developed by ISSB. Almost all of the adverse impact throughout the supply chain will also have financial materiality. This means there is a large intersection between CSRD and the work of EFRAG. There can also be a useful intersection between the European Sustainability Reporting Standards (ESRS) and the standards being developed by ISSB. There is broad scope for alignment here, such as using the same definitions. However, it is worth remembering that different institutions have slightly different mandates. CSRD fulfils many policy objectives which are clearly not in ISSB's mandate. This should not be a distraction: there is considerable common scope and a substantial amount of common good work going on.

An industry representative noted, as a preamble, that one objective of sustainability reporting is to bring transparency on how and whether a company is really embedding sustainability at the heart of its business activities and development. It is also a means to encourage a behavioural change.

EFRAG's significant efforts to produce a comprehensive set of standards in a limited time should be acknowledged. It took on board many comments from the exposure draft stage, including calls to further align with the direction being taken globally where possible. Indeed, interoperability is critical for global players. The existence of a dialogue between EFRAG, ISSB and GRI on interoperability is very positive. It will be important to see the outcome of such dialogue when the respective final standards are issued.

It is expected that ESRS will incentivise companies to think about their sustainability practices and, as a result, they have the potential to promote changes in companies' behaviour. However, they set the bar very high. They are comprehensive, extensive, and occasionally very granular. This will represent a major challenge for companies, particularly newcomers that are unfamiliar with the preparation of non financial information. The quality of sustainability reporting is contingent on the quality of the standards, but it also depends on the quality of the information systems and internal controls. In that respect, the smaller companies being brought into CSRD are not yet sufficiently equipped with the requisite systems and controls. As a result, these firms will need time to implement. It is essential to acknowledge that it will take time to get quality data. This means there is a need for a greater degree of phasing in.

It is important to remember that Europe's sustainable finance action plan is very ambitious. It is not only CSRD; there are plenty of other new texts to apply, such as the environmental taxonomy. Companies have been struggling to implement the reporting for the two climate change objectives in the taxonomy for the past two years. Earlier this month, the Commission released its draft delegated act for the four other environmental objectives and made changes to the requirements for the climate taxonomy, with an application date for reporting in 2024. This means companies should already be collecting 2023 data to report in 2024 while also working on preparing the upcoming ESRS reporting. Taken in sum, these new requirements create a significant implementation burden. It would be appreciated if the European Commission could ensure a greater degree of coordination and take a broader view on enabling companies to implement these very important regulations. The European financial industry needs the resulting information, but coordination, streamlining and phasing in are necessary to ensure that good quality information is produced.

3. The situation in the USA, Switzerland, and Japan

An official (Hester M. Peirce, speaking only for herself as an SEC Commissioner) reported that the Securities and Exchange Commission (SEC) has proposed a set of requirements around managing climate risk and identifying weather or climate related effects on financial statements at a very granular level. This includes a large number of quite particular disclosure requirements, which are designed to make climate a bigger part of companies' decision making. The SEC's limited scope of authority is important to bear in mind as we discuss convergence: its role is to ensure that there is financially material information, which is information that affects the long term financial value of companies, not to provide information to other stakeholders. A large amount of the feedback received by the SEC has focused on Scope 3, and there were also questions around the impact on smaller entities and the timing of disclosures. Additionally, the Supreme Court's 'major questions' doctrine, could affect the scope of the final rules.

An official stated that Switzerland is an example of a jurisdiction that will not introduce its own disclosure rules. Switzerland has decided not to add to the fragmentation of the market. It is not worried about comparability, interoperability, or convergence. Instead, it is focused on the development of feasible, reliable, credible, and effective disclosure. Switzerland's work in this area is principles based. Its disclosure rules have been introduced for large listed-companies and will come into effect in 2024, which will include all three scopes, double materiality, and transition plans. When ISSB has published its work, Switzerland will decide whether to converge or introduce it into its standards. The use of forward looking metrics is particularly important because these are more relevant to climate decision making. Science based targets are also a key topic in Switzerland. Switzerland wants comparability, comprehensiveness, and reliable data. It will remain at the forefront of this topic, taking a principles based approach.

An industry representative emphasised that Japan is in a similar position to Switzerland in the sense that Japan is looking at the US, Europe and ISSB. As of April 2022, Financial Services Agency Japan (JFSA) and the Japanese stock exchange required large companies listed in the prime market to report based on TCFD or an equivalent standard. As of March 2023, JFSA is requiring all companies issuing securities to report their sustainability strategy. This requirement is broad based, though there is some detail regarding human capital. It is understood that JFSA is taking this broader approach because it is waiting for ISSB to finalise its standards. The Sustainability Standards Board of Japan (SSBJ) will be drafting its standards based on the ISSB's. The issue of convergence, comparability, interoperability in the area of sustainability reporting is something Japan will have to address down the road. As a comparison, on the accounting side, there are four different standards (IFRS, modified IFRS, US GAAP, Japanese GAAP) that can be used in Japan. Hopefully, this type of fragmentation will not happen again in relation to sustainability reporting.

4. Implementation challenges: scope 3, SMEs, and capacity-building

An official (Hester M. Peirce, speaking only for herself as an SEC Commissioner) outlined the SEC rule's approach on Scope 3 disclosures. In the SEC's proposal, if a firm has public Scope 3 targets or its emissions are material, it must disclose them. Even if a company only has to disclose them if they are material, has all companies may have to calculate them to determine if they are material. A safe harbour was also contemplated, but the SEC received many comments indicating concerns about whether the proposed safe harbour was adequate. Smaller companies such as farmers and other small businesses have also pointed out that public companies with Scope 3 burdens will mandate that the companies in their supply chains also comply with these rules. Even if the SEC does not adopt a Scope 3 requirement, other requirements within the proposal deal with value chains and thus entities in public companies' value chains may still feel the effects of the rule.

An official noted that ISSB received extensive feedback on the importance of proportionality. In finalising the standards, ISSB has done several things to address this issue. For example, companies with more limited resources can provide qualitative instead of quantitative information in some instances. ISSB has also developed a measurement framework for scope three emissions that requires firms to do what is reasonable for them. The use of estimation rather than direct measurement is acceptable if the process is explained. Onboarding is crucial. ISSB is keen for firms to start on this journey. ISSB needs to help people learn this new language, and eventually they will become fluent in it. At the beginning, there will be estimation, approximation, and qualitative information. It will become more quantitative over time.

The work of ISSB begins with drafting the standards, but it will quickly move into capacity building. The discussions about capacity building were initially to do with the global south, but it has become clear that capacity building is needed across markets globally. This is a new way of reporting even for sophisticated companies in developed economies.

An official noted that EFRAG is also working on capacity building. First, it is going to provide implementation guidance and open an access point for questions and answers because it is somewhat difficult for people to navigate the ESRS. Secondly, it is going to create an ESRS e hub where documentation will be available. Finally, it is collaborating with other bodies on education. Additionally, biodiversity is high on the agenda politically and economically. Everybody realises that it is a key goal. However, the field is much less mature than climate. EFRAG has produced a draft standard called E4, which is a significant step because it is highly principles based. The Commission will have to make a decision on phasing, but EFRAG is prepared to work with TNFD and others on biodiversity. ISSB will also be consulting on the agenda in respect of how and when to approach biodiversity. In general terms, sustainability-related data is currently nowhere near where it should be. The European financial industry needs to do what the Romans called festina lente. 'Hurry but do it in proportion'.

An industry representative agreed that capacity building is a challenge. The auditing profession is investing in accompanying companies meet these challenges. Investments are being made in the audit and professional services firms to elevate professionals' knowledge on ESG matters, to recruit ESG experts and to develop tools and methodologies. Auditors' institutes are also playing a significant role here to embark not just the large players, but also the smaller and medium size audit firms, as there is a need for capacity-building in this audit segment as well. The smaller non-listed entities included in the CSRD, and those in value chains, are not necessarily audited by large networks. They also need to be accompanied by their auditors on the journey.

An industry representative emphasised that, while Morgan Stanley thinks about capacity building both internally and externally, it is important not to tamper with innovation. In Morgan Stanley, there is a considerable degree of governance, controls, and oversight on ESG related activities. It is important to make sure innovation is encouraged inside financial services and capital continues to be directed to the technologies and solutions that can help decarbonise and reduce, capture and lower emissions at the necessary rate of speed.

5. Progress on biodiversity and other nature-related reporting standards

An official highlighted that biodiversity is high on the agenda politically and economically. Everybody realises that it is a key goal. However, the field is much less mature than climate. EFRAG has produced a draft standard called E4, which is a significant step because it is highly principles based. The Commission will have to make a decision on phasing, but EFRAG is prepared to work with TNFD and others on biodiversity. ISSB will also be consulting on the agenda in respect of how and when to approach biodiversity. In general terms, sustainability reporting is currently nowhere near where it should be. The European financial industry needs to do what the Romans called *festina lente*. 'Hurry but do it in proportion'.

An industry representative agreed with these comments, including the need for *festina lente*. TNFD is trying to be what TCFD has been for ISSB's S2. A lot is being learned from EFRAG's work. Although TNFD copies much of what TCFD has done, it has also developed six new general requirements. The first of these requirements is about the approach on materiality. TNFD is trying to be neutral on materiality and let the reporter explain their approach. The building blocks are similar to what is in the Global Biodiversity Framework (GBF). It includes impact, dependency, risk, and opportunities. TNFD is taking a maximum approach that is also flexible and allowing companies to choose which materiality approach to take, so that the framework will be interoperable across jurisdictions.

An official noted that Switzerland is very supportive of TNFD. As another speaker has mentioned, there is a need to bring companies to the point where they can use the standards and make disclosures in a meaningful way. Switzerland created a national consultation group amongst its financial institutions and companies to test the TNFD recommendations before they are finalised. This is helpful for TNFD, but it also gives Swiss companies the chance to gain some experience of the standards before they enter force. It is essential for ISSB and others to build closely on the TNFD network when considering the approach to take in biodiversity. The complexities and challenges are well known. In this context, it is also important to bear in mind the need for location specific data and the acceptance of more diverse situations than apply to climate.

An official explained that ISSB would soon be publishing a request for information to determine its next focus. Four candidate projects have been identified by staff's research: biodiversity, ecosystems, and ecosystem services; human capital, such as diversity, equity, and inclusion; human rights, such as supply chain issues; and whether ISSB should work further on integrating the reporting between financial statements and sustainability reporting. ISSB wants to know which of these projects are important to market participants for prioritisation, how it should proceed and which existing materials it should refer to, to build upon.

The Chair noted that the panel had identified three key challenges to progress towards reporting standards. Clearly, substantial progress has been made. There are implementation challenges, but all of the panellists' organisations are trying to develop practical ways to overcome the challenges and bring their respective stakeholders on board. Additionally, biodiversity is becoming part of the reporting agenda. In light of the important progress that has been made so far, efforts are underway to support the inclusion of biodiversity risks and opportunities in the mainstream of sustainability reporting in the years ahead.