THE INTERNATIONAL HARMONISATION OF ESG STANDARDS: A CHALLENGE AND A NEED

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1. The international «alphabet soup» of ESG standards and disclosure requirements

Today the international landscape of ESG (Environment, Social and Governance) reporting, including on climate change, is complicated and may even seem confusing.

1.1 There is a proliferation of ESG standards and disclosures requirements developed by a number of standard setters

Most of them are based on international private initiatives, with sometimes the participation of the United Nations (the UN Sustainable development goals are a source of inspiration for most of the standard setters), notably the Global Reporting Initiative (GRI), the International Integrated Reporting Council (IIRC), the Carbon Disclosure Project and the Climate Disclosure Standards Board[1].

The most important standard-setter in the United States is the Sustainability Standards Accounting Board (SASB)[2], which has an international reach and has developed international activities, in particular by the creation of the Value Reporting Foundation with the IIRC.

In the European Union, ESG disclosures have been regulated for some time both at national and at EU level. The Non-Financial Reporting Directive (NFRD) was adopted in 2014 and currently applies to large public interest entities (listed companies, banks and insurance companies); it does not establish reporting standards but only some principles and leave the choice of standards to the corporates. The EU's legal framework has recently been developed under two regulations: the Sustainable Finance Disclosure Regulation (SFDR) was adopted in 2019 and applies to financial market participants, such as asset managers, and to financial advisors. Further ESG disclosure requirements flow from the Taxonomy Regulation adopted in 2020.

In China there are only reporting requirements for certain high-polluting listed firms.

1.2 There are significant differences between the USA and the EU on ESG standards

First, there is no definition of «sustainability» in US law and no ESG focus on US financial regulation, contrarily to the EU legal framework.

Secondly, SASB standards, which are merely voluntary, are different from EU disclosure requirements on two key aspects:

- they are based on comparability inside one industrial sector and not on an intersectoral basis.
- they rely on an assessment of ESG risks for the firm (simple materiality), when in the EU there is also an assessment of the impact of the firm on its environment and stakeholders (double materiality).

The source of these differences is probably because the US framework is still focused on the financial and economic performance of the firm, whereas the EU framework includes also the ESG perspective.

These differences are a challenge for European firms, given the weight of US investors in Europe, and vice versa.

1.3 As for the specific standards and disclosure requirements on climate change, there have been three major international developments

The first positive international development has been **the endorsement by the G20 of recommendations of the Task force on Climate-related Financial Disclosures (TCFD)**, which are more and more implemented by the biggest financial actors, but which contain more recommendations on governance and methods than on standards. The TCFD's recommendations are likely to be the basis for further development of climate-related disclosures in most jurisdictions and seem to have broad support within key international fora such as the Financial Stability Board and the central banks represented in the Network for Greening the Financial System.

1. Private international standard-setters:

- The Global Reporting Initiative (GRI), created in 1997, is an organisation based in Amsterdam, regrouping NGOs, corporates, accountants and in relationship with the United Nations. Its sustainability reporting framework provided by the GRI Standards is said to be the world's most widely used and trusted framework. It has been adopted by the world's largest corporations and referenced in policy instruments and stock exchanges.
- The International Integrating Reporting Council (IIRC), created in 2010, is a global coalition of regulators, investors, companies, standard setters, the accounting profession, academia and NGOs, incorporated in the United Kingdom. The coalition promotes communication about value creation, preservation and erosion as the next step in the evolution of corporate reporting.
- Carbon Disclosure Project (CDP) and Climate Disclosure Standards Board (CSDB) are part of the same group:
  - CDP, founded in 2000, is an international non-profit organization, registered in the UK, that runs a global disclosure system for investors, companies, cities, states and regions to manage their environmental impacts;
  - CDSB, also based in London, is an international non-profit organization, created in 2007 by the CDP. It is a consortium of business and environmental NGOs, amongst them SASB, which offers companies a framework for the integration of climate change-related information into mainstream financial reporting;
  - CDP acts like the secretariat of CSDP.

2. The Sustainable Standards Accounting Board (SASB) is an American non-profit organization, founded in 2011; its stated mission «is to establish industry-specific disclosure standards across ESG topics that facilitate communication between companies and investors about financially material, decision-useful information. Such information should be relevant, reliable and comparable across companies on a global basis.».

Secondly the EU has taken the lead with the regulation on taxonomy of climate change adaptation and mitigation which will be finalized soon. This regulation contains also a «no do significant harm» principle in the ESG field.

Thirdly, following the last American elections, **the political priorities of the US, the EU and many other countries are now aligned** on climate change policy and a convergence seems possible.

1.4 The Green bond market and the Social bond markets are rare examples of relative harmonisation of standards

The Green bond market, which has grown very quickly in the recent years (305 B $ in 2020), is based on Common principles created in 2014 and regularly updated by the International Capital Market Association (ICMA). These principles are used by over 95% of issuers in the European and international markets (including China which has created its own regulatory standards). There is also a complementary market-based green taxonomy provided by the Climate Bonds Initiative that are sector specific, developed by scientists and industry experts.

The Social bond market is another example of relative harmonisation of standards on the model of the Green bonds. Its development is more recent but has been very significant in 2020, particularly after the start of the pandemic, reaching 148 B $.

The European Commission has undertaken to publish a legislative proposal on an EU Green Bond Standard in 2021.

2. The need for convergence

2.1 Both the financial and non-financial sectors are negatively impacted by this «alphabet soup» of ESG standards and disclosure requirements

The number of different standards is a real burden for European corporates, which have, for instance, to answer too many different questionnaires from financial investors and ESG rating agencies. It raises costs, both financially and in human resources, which is deeply resented by Small & Midcaps.

Moreover, it does not favour comparability, the public sharing of ESG data and finally a real ESG transparency.

A recent report of the Boston Consulting Group (BCG) commissioned by the Global Financial Markets Association (GFMA) sees «ambiguity and lack of clarity» as a major obstacle to sustainable finance[3]. The report deplores «inconsistent and incomparable ESG-data, limited mostly to large corporates», «the lack of common definitions and taxonomies for climate/sustainable finance» and «the unclear understanding of sustainable financial products and solutions, and unclear labelling».

Most of the standard-setters and regulators also regret this situation. IOSCO is concerned by the lack of comparability of the information of the investors, underlined in a communiqué in February 2021: «for its work on issuers´ disclosures, IOSCO has observed that investor demand for sustainability-related information is currently not being properly met. For instance, companies often report sustainability-related information selectively, referencing different frameworks»[4].

2.2 A minimum level of convergence would be a very strong supporting factor towards global sustainability

It could allow the establishment of a framework that guarantees the high quality, reliability and accessibility of ESG and climate data, which is essential to accelerate the implementation of a sustainable economy, leveraging digital platforms as much as possible. This would reinforce the incentive for corporates to accelerate their transition and would provide a better transparency to investors who are increasingly keen to understand and monitor the sustainability impact of their investments. The dissemination of comparable ESG data would also help the development of best practices.

As for climate change, the report by the GFMA and the BCG underlines the necessary and huge structural financial changes to fight climate change and stresses in one of its key recommendations: "We recommend mandatory disclosure of corporate-specific, financially material, decision-relevant data relating to climate risks and opportunities". For GFMA and BCG, consistent global disclosure frameworks should be developed in consultation with industry participants and with adequate runway for implementation.

3. The possible roads to convergence

3.1 Many standard-setters have started to work on this issue

Last September, five standard-setters — the Sustainability Accounting Standards Board, the International Integrated Reporting Council, the Global Reporting Initiative, the Carbon Disclosure Project and the Climate Disclosure Standards Board — came together to announce plans to align their climate standards more closely. Since then, SASB and IIRC announced plans to merge together into a group called the Value Reporting Foundation by the middle of 2021, and CDSB may be joining them as well.

The IFRS Foundation plans also to develop climate standards before the end of the year. And IOSCO has decided to support this project[5].

At the EU level, a taskforce of the European Financial Reporting Advisory Committee (EFRAG) published mid-March 2021 a report calling for «promoting a mutually reinforcing cooperation between EU standard-setting efforts and international efforts or fora». the taskforce recalled that «the EU is by tradition and by construction among the jurisdictions which are the most open to international cooperation and convergence» and recommends cooperation and partnership with

3. The Global Financial Markets Association and the Boston Consulting Group: « Climate finance markets and the real economy », December 2020.

4. IOSCO: « IOSCO sees a need for globally consistent, comparable and reliable sustainability disclosure standards and announces its priorities and vision for a Sustainability Standards Board under the IFRS Foundation », February 2021.

5. EFRAG European Reporting Lab: « Proposals for a relevant and dynamic EU sustainability reporting standard-setting », February 2021.

international partners and initiatives but «without slowing down the momentum achieved in the EU». Indeed, it stressed that «international initiatives cannot in the short term match the speed and scope of EU's level of ambition».

GRI has positively commented this report, saying that it sees clear alignment with EU's sustainability standard setting efforts and is ready to assist. CDSB was more nuanced: it welcomed recommendations on international co-construction and digitalisation but cautioned around areas of duplication that can be avoided.

In the United States, the SEC has just launched a public consultation on climate change disclosures[6].

3.2 To avoid confusion, the international convergence regarding ESG disclosures should be led in priority by the G20 and the FSB

There is a need for simplification and for speed, notably for the climate change standards. Public authorities at the international level should be in the lead and that is the normal role of the G20 and the FSB, especially now that the new US administration should support them.

At the same time, the EU should play a major role in this convergence:

- by building on its experience based on the Non-financial Reporting Disclosure Regulation and on the Sustainable Finance Disclosure Regulation.
- and through the international platform on sustainable finance which it has created.

As for climate change, the EU is in pole position with the development of the taxonomy regulation. The international platform, which was created at the EU initiative, has a working group on non-financial standards which has started to work on the EU taxonomy.

The NGFS (Network for Greening the Financial System) of central bankers and financial supervisors could also help the convergence in this field.

3.3 On climate change, significant progress seems possible

Indeed, due to its political priority in the EU and many other countries, and now that the US is back, willing to engage into an ambitious transition to a zero-carbon economy, significant progress seems possible.

The COP 26 in Glasgow, under the UK's Presidency, is an opportunity which should not be missed.

Building on last year B20's recommendation to "promote alignment on disclosures across ESG factors to enhance reporting by publicly traded corporations", the G20 should mandate the FSB to step up its ambition in the work of the Task Force on Climate-Related Disclosure with the view to make key climate disclosure mandatory as soon as 2025 for all listed corporates in all jurisdictions.

The creation of a Global climate taxonomy should be a common goal of standard setters. It is supported by the GFMA/BCG report which notably recommends "a regional and temporal flexibility" and "the inclusion, beyond the zero or near zero carbon activities, of transition or enabling activities which are scientifically eligible activities".

This Global taxonomy could be built on the work already done by the EU, which is in the process of finalizing its regulation with a high level of detail. The European Commission should increase the exchanges about the climate taxonomy with its partners in the international platform before its implementation in Europe.

3.4 On the other parts of ESG, convergence risks to be slower

In this field, we could quote Kierkegaard: "it is not the path, which is difficult, it is the difficult which is the path". Given the differences of standards between constituencies like the EU and the United States (cf. 2 above), only a significant involvement of the SEC could make US-EU convergence easier.

In this background, bodies like IFRS/IASB cannot achieve much, since US apply their own standards and the EU is contemplating the opportunity to have its ESG standard setter.

However, to support international convergence, the EFRAG TF recommends that the EU develops a regular outreach to other international standard-setting bodies by communicating regularly on its work-plan, share progress reports, open consultations to non-EU comments and offer the outcome of its work as a contribution to international convergence. It also recommends to «consider joint projects to develop new standards under clear terms of reference» and suggests that «dialogue with the IFRS Foundation be organised once the Foundation has set a possible course of action».

A possible goal for convergence would be an agreement on an international grid of minimum standards, but, for Europeans, supported by the GRI, the «double materiality» should be part of this grid.

Conclusion

Financial and non-financial actors ask for as much international harmonisation of ESG standards and disclosure requirements as possible.

Today convergence seems possible for climate change standards which has become a priority also in the United States, as evidenced by the public consultation recently launched by the SEC. The COP 26 in Glasgow could be a catalyst in this process, where it seems possible to build on the work already made, notably by the European Union.

Convergence would be also needed on other ESG standards, but where the differences seem more difficult to be reduced and where the political priorities are lower outside the European Union.

6. SEC: « Public Input Welcomed on Climate Change Disclosures », March 2021.