COEXISTENCE OF SUSTAINABILITY REPORTING STANDARDS

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The European Union can be proud of its sustainability standard-setting framework

Sustainability reporting standards are of special importance in the fight against climate change and towards the goal of building a capitalism of stakeholders. They are not an end in themselves, but a tool enabling corporates and their stakeholders to act. They should bring the necessary information to financial institutions allowing them to finance the transformation of our economy, as well as to corporates and governments to plan this sustainability transition, and to regulators and civil society to hold economic and financial players accountable for their actions, or lack of action. Sustainability data need to be reliable, comparable and decision-useful in order to be an incentive for change. It is a question of knowing better in order to act better.

France has introduced ground-breaking regulatory requirements in terms of sustainability reporting some 20 years ago. The EU has followed in 2014 with the Non-Financial Reporting Directive. Despite incremental improvements, the information still lacked standardization to be truly comparable and usable by stakeholders. This is why the Corporate Sustainability Reporting Directive – finalized under the French Presidency of the Council of the EU – is such an important step forward. It provides for the most ambitious and complete set of standards in the world – covering both the impacts a corporate has on the environment and on society and the risks linked to sustainability that it faces, and covering the whole spectrum of ESG. It will make it mandatory for more than 50 000 European corporates to report according to these standards, and to digitalize the information for it to be included in a European Single Access Point – gathering corporate financial and sustainability data in a freely accessible platform.

To provide for a proper understanding of the impact a corporate has on its environment is key.

Several jurisdictions are starting to implement or to consider adopting regulatory requirements in terms of sustainability reporting – but few support disclosure on the impact of corporates. However, the impact of our economic activity is precisely the information which should be guiding our transformation – not the individual climate-related financial risk a company is facing. Achieving the Paris Agreement implies deeply questioning and transforming our strategies and corporates business models to make them climate neutral. It is a distinct objective to the one of ensuring financial stability and managing climate risk – however important this other challenge is. Initiatives have emerged at the international level to bring more standardization to the market, claiming that it will help solve the climate challenge. Then, there is an absolute necessity to provide for a proper understanding of the impact a corporate has on its environment.

Multilateralism should provide leadership to improve coordination and convergence on sustainability standard-setting, based on the basic principle of allowing the real transformation of our economy towards the achievement of our common climate and sustainability goals. But to allow for acceptance and ownership, international standards or principles should build on what jurisdictions are working on. Otherwise, they would run the risk of not being fully owned by stakeholders or even not implemented.

There is still a long way to go for sustainability data to be standardized even for climate at the international level. Given the urgency of the challenge, climate should be our priority for multilateral discussions, alongside exploring other environmental topics like biodiversity, even though the EU has chosen for itself a more comprehensive framework covering all environmental, social and governance matters because of its social model and traditions. The best being the enemy of the good however, it appears more efficient to focus international discussions on well identified priorities like climate and biodiversity, instead of achieving no consensus at all. The Taskforce on Nature-related Financial Disclosure is for example a significant step in the right direction, at a time where all jurisdictions are fumbling around to determine which metrics should be used to appropriately reflect impact on biodiversity and biodiversity-related risks. Unlike climate matters, this topic is not mature enough yet to have been covered thoroughly at the national level, hence providing a fertile ground for international work.

On the other hand, any work at the international level on social matters should be particularly mindful to respect national social contracts and political traditions, especially the heritage reflected in national constitutions.

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The global baseline – part of a bigger picture

The establishment of the International Sustainability Standards Board (ISSB) was announced by the IFRS Foundation (Foundation) in November 2021, at the COP26 climate conference, in response to demand from market participants and requests from the G7 and G20 that the IFRS Foundation assist in addressing the complex and fragmented landscape of corporate sustainability reporting. Finance Ministers and Central Bank Governors from over 40 jurisdictions on six continents officially welcomed the Foundation's goal to create a comprehensive global baseline of sustainability disclosures focused on meeting the needs of capital markets.

In the past six months a lot has been achieved, but the ISSB did not come from nothing and does not operate in a vacuum.

The ISSB was given a running start by consolidating with the VRF (which houses the SASB Standards and the Integrated Reporting Framework), as well as the Climate Disclosure Standards Board (CDSB). This consolidation means that we benefit from the existing materials of the VRF and CDSB and their people and processes and enables us to accelerate our work to remove complexity from the reporting landscape, streamline reporting and make the resulting information prepared by companies more useful to investors for their capital allocation decisions.

The ISSB's first two proposed standards have been published – a draft climate standard and a general requirements standard, complete with industry-based requirements, fully embedding the TCFD framework and building on the SASB's industry-based standards. Our consultation closed at the end of July and we are now working through the feedback we received on our proposed standards.

This consolidation of efforts has allowed us to achieve a significant amount in a seemingly short space of time, by building on the work of others while enabling our stakeholders to provide their comments through our inclusive consultation process.

Ultimately, our objective is to provide standards that produce comparable, high-quality information about the effects of sustainability-related risks and opportunities for the capital markets across the world. In building this comprehensive global baseline, we are seeking to create a common language for sustainability information for the capital markets. We are conscious of the bigger landscape in which we operate and that we can create better standards if we collaborate.

As countries around the world look to make changes to reposition their economies to a sustainable and resilient system, we will continue to engage with jurisdictional authorities and market participants, including EFRAG, the US SEC and other jurisdictional initiatives. Through this dialogue, we are seeking to reduce differences between the ISSB's proposals and jurisdictional proposals as well as working together to establish the ISSB's global baseline. This engagement also includes working closely with the International Organization of Securities Commissions (IOSCO) as it evaluates whether to endorse standards issued by the ISSB.

This global collaboration is important in delivering our building blocks approach. It is our goal that IFRS Sustainability Standards provide a global baseline of disclosures that facilitate comparability in global capital markets while also enabling particular jurisdictional information needs and/or to any incremental information needs of stakeholders beyond investors to be met. Using a building block approach incremental disclosures can be required that build upon the global baseline.

Furthermore, we are establishing the necessary advisory and consultative bodies that will serve as a platform for enhanced collaboration with other international organisations, jurisdictional authorities and representatives of other stakeholders. These arrangements provide an essential mechanism to allow stakeholders to help shape IFRS Sustainability Disclosure Standards and to facilitate compatibility with broader jurisdictional requirements.

As the comment period on our Exposure Drafts comes to a close, we can now benefit from a great depth of analysis and input on our draft standards. At the last count over 30,000 people from a wide cross-section of stakeholders have engaged in our outreach activities. The insights we have obtained from this outreach, along with the results of the comment letters and survey results we received on the Exposure Drafts will prove invaluable as we begin our deliberations to finalise our proposals.

One important message that we are already aware of through our outreach activities, has been the concept of proportionality. It is clear, that we must ensure our standards are fit for global application, not just for large companies and developed markets, but for smaller companies and emerging economies. We are committed to creating standards that are truly global and suitable for all jurisdictions to implement. In short, we want the global baseline to be truly global.

Although we have made strong progress to date, we are still rounding the first bend of this journey and a significant amount of work still needs to be done to ensure our standards can support the efforts of the global community in meeting the challenge of transitioning to a sustainable global economy. Much will need to be done, including in partnership with others, to finalise and then successfully implement the ISSB's standards around the world.

The ISSB is one part of a larger ecosystem. We benefit from the insights and initiatives happening globally, and we are working collaboratively to play our part in developing standards to bring high-quality, comparable sustainability-related financial information to facilitate decision-making in the capital markets.

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CSRD : a cornerstone of the EU's sustainability agenda

On 21 June, the European Parliament and the Council reached political agreement on a cornerstone of the EU's sustainability agenda and the European Green Deal: the Corporate Sustainability Reporting Directive (CSRD).The co-legislators confirmed the main elements of the Commission's CSRD of April 2021:a wider coverage of companies than is currently the case under the NFRD, the introduction of an assurance requirement, the digitalisation of sustainability information and the introduction of mandatory EU sustainability reporting standards. The European Financial Reporting Advisory Group (EFRAG) will develop the draft standards and the Commission will adopt the final standards as Delegated Acts. The CSRD and accompanying standards will ensure that corporates disclose the sustainability information necessary to underpin the rest of our sustainable finance agenda.

In April 2022, EFRAG's newly established Sustainability Reporting Board released for public consultation a first set of thirteen draft European Sustainability Reporting Standards (ESRS) covering all environmental, social and governance aspects. The next step will be for EFRAG to analyse the responses to the public consultation and to make any revisions that it considers necessary according to its due process, before submitting final drafts to the Commission in November 2022. EFRAG's due process will ensure that the final draft ESRSs strike the right balance between the information needs of users and the burden for preparers.

EU standards must be coherent with the EU's political objectives and with the existing legal framework for sustainable finance which means that EU standards will address all ESG issues from the beginning. The final drafts must meet the mandate set by the CSRD which confirms that the Commission will adopt a first set of ESRS by June 2023,with a second set of standards, including sectors-specific standards and standards for listed SMEs, to be adopted in 2024.

CSRD and accompanying standards will ensure stronger sustainability reporting rules for companies.

Listed small and medium-sized enterprises (SMEs) are included in the scope of the CSRD because they risk being excluded from investment portfolios if they do not provide the same quality of information as large listed companies. To ensure proportionality, listed SMEs have a lighter reporting regime, including the option to use simpler, proportionate standards and a possibility to opt-out from the reporting during the first two years. The CSRD does not propose any mandatory requirements on non-listed SMEs, which is the overwhelming majority of SMEs but they would be able to use the standards for listed SMEs on a voluntary basis. This should help them deal with the increase in demand for information from company clients, the financial sector and others.

At international level, there are several standard setters dealing with climate and sustainability reporting. The International Sustainability Standards Board (ISSB) has issued two Exposure Drafts by March 2022 on climate and general sustainability-related disclosure standards. The US Securities and Exchange Commission (SEC) has also released a proposal to enhance climate-related disclosures for companies.

ESRS will cover all sustainability aspects under a double materiality perspective. This means they address how sustainability issues create risks and opportunities for the company and provide also an objective account of the company's own impacts on people and the environment. ESRS aim to serve the needs of investors and other stakeholders such as civil society organisations, trade unions or citizens. In contrast, the ISSB standards and the SEC proposal cover climate related-aspects only–no other environmental issues such as water or biodiversity and no social or human rights issues. In addition, they only look at financial materiality relevant for investors, the so-called enterprise value creation but not explicitly at company impacts.

It is difficult in practice to split sustainability information reported under financial materiality and impact materiality as many impacts of companies become financially material, in particular in climate disclosures. ESRS, by addressing both financial and impact materiality in the same set of standards, provide a single, coherent sustainability reporting solution for companies and for users of information.

The CSRD does not foresee the adoption of ISSB standards in the way that International Financial Reporting Standards are adopted by the EU. Rather, EU standards will integrate the content of ISSB standards to the extent that it is consistent with the EU's legal framework and the ambitions of the European Green Deal. The Commission together with EFRAG is participating in the ISSB jurisdictional working group and has started bilateral discussions with the ISSB to achieve as much interoperability as possible between ESRS and ISSB standards.

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Sustainability Reporting challenge: Companies and investor demand

Investors require high quality ESG data to assist asset allocation, decision-making and reporting requirements. Anticipated reporting standards will help to support these demands, provided challenges are addressed.

As reporting standards from the EFRAG and the ISSB make their way through the drafting process, towards adoption and into eventual practice, potential challenges are becoming clearer. Investors are seeking high quality ESG data to assist asset allocation, decision-making and reporting requirements. As an ESG solutions provider with experience in reviewing and evaluating disclosures to support investors decision-making, Moody's ESG Solutions see three main challenges ahead of the respective sustainability reporting standards initiatives to address.

Implementing the new reporting standards will take (too much) time

Standards that jurisdictions mandate resulting in consistent and comparable disclosures across economies will be a boon to increasing transparency, reducing greenwashing and driving capital to high performers. The EFRAG exposure drafts standards are a level up from requirements of its predecessor, the Non-Financial Reporting Directive. The ambition shown is commensurate with the multiple and complex challenges at hand and in supporting ambitions of the Green New Deal for Europe and the Strategy for Financing the Transition to a sustainable economy.

Demands for ever more granular data across a range of ESG-related domains are growing. Investors want consistent and reliable information and data across economic activities that provide them with the comprehensive coverage helping them understand potential exposure to risks and opportunities across highly diversified portfolios. Investors are asking companies like us at Moody's ESG Solutions for this data now. This cross-economy information need is urgent. At present the new requirements will apply to companies already in scope of the Non-financial Reporting Directive in January 2024 and those not in scope of the NFRD in January 2025.

Faster adoption by companies in scope will lead to reporting practice scaling and skilling up, which will take a number of reporting cycles, and meeting investors' demands at the earliest opportunity. We already see many investors looking to bridge data gaps with modelled solutions, where disclosures are not available. This can lead to further fragmentation in the sustainability reporting market.

Coordinated standards are needed in delivering the high quality ESG data investors need.

Risk and impact considerations are needed for a complete picture of ESG performance

Both standards have adopted different materiality approaches. The European Sustainability Reporting Standards employ a double materiality approach, while the ISSB uses enterprise value as underlying materiality concept.

At present, it is unclear whether efforts to enhance interoperability will be enough to ensure that the different materiality approaches will not lead to a bifurcation of material issues identification, management and reporting by companies. While there are efforts to improve coordination between both standards (notably the jurisdictional working group and ongoing bilateral engagement activities), a fragmented result on this key topic will fail to serve investors.

Difference in approaches to materiality taken by the two standards may also hamper further deepening of understanding of the interconnectedness and interdependence of material ESG factors across businesses and stakeholders domains. At the same time, it will be important that the complementary role of GRI reporting (focused on impact and globally the most widely used sustainability reporting framework) is well integrated, alongside future ISSB and EFRAG standards, so that both elements of material issues are covered by reporters to provide investors with useful, more complete information.

Delivering high quality ESG data for increasingly complex issues is a growing challenge

Some data is still a challenge for companies to report at the level required by investors. Consider scope 3 climate emissions data: despite recognition that for many companies, scope 3 accounts for the majority of their emissions, disclosure rates are still very low. Other topics such as biodiversity suffer from poor adoption of management and measurement practices leading to insufficient disclosure levels compared to other more established environmental topics. Will the standards be part of the solution to solving these urgent questions? Or, will investors feel that different approaches, for example using unstructured data, or using new voluntary frameworks such as the Taskforce for Nature-related Financial Disclosures that are currently under development, can provide a better way to understand ESG exposure and impacts? Stronger links between the standards and wider efforts to support areas where data are lacking and management and disclosure are limited, can build a systems-wide approach to delivering the high quality ESG data investors need.

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Building a credible road to decarbonization

We are living in extraordinary times; fighting a persistent pandemic and coping with an energy security crisis in the short term, while facing an increasingly severe climate crisis in the medium to longer-term. When it comes to climate change, society's sense of urgency is fast rising, and the net zero ambitions and strategies of the private sector have been elevated to new hights. This is a positive development despite the deepening and continuing crises; the world must move fast if it is to tackle climate change and achieving the sustainable development goals (SDGs).

126 governments, including Japan, and numerous individual companies globally have announced their ambitions to commit to a net zero world. And while it is important for all stakeholders to state their ambitions, it is critical to articulate how the public and private sectors are going to achieve these ambitious goals, and make sure that the plans that are being announced are credible and effectively implanted to enable a just transition.

Decarbonisation pathways of the hard to abate sectors vary across countries and regions and individual circumstances of the stakeholders involved. Finance is key in enabling the transition, and the role of transition finance is particularly important in determining whether we are on track and whether the path is credible.

For financial institutions to properly allocate their funds in support of decarbonization, disclosure of relevant data and information by preparer firms is key. Over 3000+ private institutions from 92 countries with a combined market capitalization of USD 27.2 trillion are already committed to TCFD disclosure and their disclosure content and capacities will be significantly enhanced once they start reporting on climate and other sustainability subjects under the new ISSB standards, based on the four TCFD pillars.

In Japan, the TCFD consortium was established in 2019, and as of June 2022, it has 650 members, the highest number of any country. The Japanese Bankers Association has strongly encouraged global standard setters to use TCFD as the basis for a global ESG reporting standard and the JBA has been fully supportive of the ISSB's work to establish the global standard for sustainability disclosures which is based on TCFD framework.

Let us do our best to enhance transparency, consistency and comparability of disclosed data.

In order to understand what the overall transition pathway will look like, we need to rely on consistent and comparable data. Not only will this data help to understand whether we are on rack, but it will also help financial institutions and regulators as well as central banks assess and mitigate the risks to this pathway, while simultaneously seizing the opportunities to promote innovation and potentially accelerate the transition.

Mandatory ESG disclosure standards at national or regional level can cause divergence, making it more difficult to remain aligned with evolving global standards, developed by the ISSB. Therefore, it remains important that third country banks can rely on global standards for their EU-based entities.

We know that national or regional frameworks are at risk of diverging from the global baseline, which can be caused by several factors, including the ongoing political divides and geopolitical developments in the world.

While disclosure of consistent and comparable data and information is key, we should not lose sight of the need to work on our individual forward-looking transition strategies and plans as part of the overall disclosure framework. The credibility of our own transition plans is intrinsically linked to those of the clients we serve. Financial institutions must be able to provide useful advice and support to their clients' transition plans.

The financial sector is making an unprecedented shift to support the transition to a low carbon economy. We may need to accept a certain level of flexibility in the speed of the individual economies to transition. However, what we should not accept is imposing regional divergence and fragmentation that creates unnecessary burden on those institutions that need to help the transition.

Let us do our best to enhance transparency, consistency and comparability of disclosed data and information to enable the global financial system work as a part of the solution, not a drag on the transition to net-zero. Let us call on regulators and supervisors to strengthen global coordination, and thereby help create the necessary conditions for the private sector to be the driver of the just transition.

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Sustainability reporting should be as simple as possible

Sustainability reporting is a complex reporting, potentially much more complex than financial reporting.

Unlike financial reporting, sustainability reporting has multiple dimensions, each with its own specificity, technicality, and unit of measure. These dimensions are interdependent and non-fungible which makes materiality assessment more difficult. It is possible to assess and aggregate individual items in income statements and balance sheets, but it is impossible to compare or add water consumption and carbon emissions unless natural capital accounting is used. Granularity also matters, sustainability issues are often "local" by nature: they are rooted in a production unit, in a specific location or somewhere in the value chain.

Granular information is relevant but can lead to a large amount of disclosure and raise confidentiality issues. Finally, the rules are constantly evolving, as public authorities progressively impose constraints on the economy to be compatible with a sustainable state. Legislation is being developed in both the real economy and the financial sector, and one would expect sustainable reporting to show progress or compliance with these regulations.

Complexity is inherent in sustainability reporting, but it is critical that we mitigate it as much as possible. We are at the beginning of a deep and comprehensive transformation and in this context, execution is just as important as setting the right targets. We need simple, clear and precise requirements for economic actors to act with certainty.

In this regard, there is room for improvement in many of the proposals for sustainable reporting put forward by the three main bodies, the SEC, ISSB and EFRAG.

The first area of improvement is international convergence where additional clarification and practical guidance could facilitate implementation. Concepts and principles should be the same for both global and jurisdictional standards and when there are different policy choices, a reconciliation of approaches should be provided. For example, the delineation between financial materiality and double materiality is not clear, and additional guidelines and examples would be useful in this regard. Some similar metrics can also be defined differently in each jurisdiction reflecting different technical practices or regulatory requirements. The provision of comparisons and equivalences on these metrics, could facilitate the work of preparers and the interpretation of results, this can be the case for example for energy performance certificates or Scope 3 approaches.

Complexity is inherent in sustainability reporting, but iwe reduce it as much as possible.

The second area of improvement is limiting the number of disclosures and their level of granularity. All dimensions are important and by limiting the number of indicators and information we risk providing an incomplete picture, but we should still try to restrict the number of disclosures to those that are most mature and important and allow for a progressive approach on other complementary indicators. The priority indicators should be those that are already required by other regulations (e.g., in the CSRD context, the taxonomy and SFDR/ Principal Adverse Indicators) and the most mature climate related disclosures. This approach would also allow for potential future changes in regulation and practices (such as the finalization of the work of the TNFD). It would also make it easier for SMEs to implement disclosures, as even exempt SMEs could be required to comply with the full standards because they are part of a large company's value chain.

The third area of improvement is providing more precision and prescription on disclosures. This would facilitate implementation, enable comparisons and aggregation which is necessary for financial institutions, and ensure auditability. There are many examples of disclosures where additional precision and prescription would be useful, such as the materiality assessment process, the climate scenarios used for certain climate-related disclosures, or the presumption of material disclosure by sector.

A fourth area for improvement is disclosure of measurement uncertainty. Many of the reported metrics will rely on estimates and assumptions, and some forward-looking metrics will have inherent uncertainties and limitations. Categorization and disclosure of the level of uncertainty in these metrics, similarly to fair value leveling in IFRS, would be an effective way to provide transparency on data quality and would be safer for both preparers and users.

The SEC, ISSB and EFRAG have, in a very short period of time, proposed relevant disclosure standards, which are much needed in our transition journey. This is a great achievement. We should now focus now on the implementation challenges with the objective of making implementation as easy as possible without compromising relevance.