Coexistence of sustainability reporting standards (ISSB, SEC, EU CSRD/Taxonomy)

1. Recent progress despite the differences of approach

An industry representative welcomed the dynamic evolution in the field and supported the European Financial Reporting Advisory Group (EFRAG) and the International Sustainability Standards Board (ISSB). This standardisation effort provides the right impulses to companies to report. There is a need for standardised, reliable underlying data reported by companies, which data users need to avoid being caught in 'garbage in/ garbage out'.

An official welcomed as a positive development the different standard setters in different jurisdictions working on the same issue, demonstrating the importance of sustainability reporting. However, there is a risk of fragmentation and double reporting, which is useful for neither investors nor enterprises. It is key to have some consistency between the standards, and the G7 members issued a paper confirming there should be interoperable standards that work together to avoid fragmentation, and which work globally, because climate change and sustainability more broadly are global issues. The work of the ISSB and the European standard setter should, in some way, be combined so there is a global baseline. The building block approach of the ISSB can then itself be applied to add specialist standards for other jurisdictions to the global baseline.

The communiqué sent out by the G7 also highlights a desire to mobilise private funding for the transformation and to prepare the pathway towards net zero. The Commission said an additional €350 billion is needed each year in the energy system alone in order to meet the emission reduction target by 2030. Therefore, the financial sector has a crucial role to play, and the sector needs reliable, comparable data to decide where investments will have the biggest impact. Reporting standards that can be implemented globally are therefore key.

An official confirmed the ISSB has just closed the comment letter period on two exposure drafts, for which it received nearly 1,500 letters. It is busy processing those and there is a great deal of very good feedback.

It could be commented that there is a complicated landscape, with the ISSB, EFRAG, the US and others. However, this is an opportunity to see where there are opportunities to align. The message from the feedback letters was strong support for the idea of the global baseline, because of the global nature of markets and the efficiency for companies if they are able to use the same requirements in different parts of the world. There was also a strong message that it is important for the ISSB to find ways to work with others for the sake of interoperability with the various jurisdictions. That is being worked on and progress is being made.

The Securities and Exchange Commission's (SEC) proposed climate rules possess a large amount of commonality with what the ISSB has proposed. Comparing the ISSB's work and that of EFRAG, there is again a common core that both are interested in. There is focus on meeting investors' information needs and the interest is not only in climate.

As the ISSB is interested in investor information needs and EFRAG is interested in the needs of a broader range of stakeholders, including investors, there is a real opportunity to work together to find a common set of disclosures that are applicable in both circumstances and bilateral conversations are ongoing.

The hope is that a good intersection of information that is a common set of information needs will be found. Then the key is to make sure that within a set of disclosures that provide a broader perspective, which EFRAG does from a European perspective, that common set of information that is investor relevant is visible to investors. If they pick up a set of European disclosures, they should see the global baseline of information and make global comparisons. That is what is being worked on. There is much work to do, and some more time would be welcome, but this is a positive development.

An official suggested the perspective of the US, and many other jurisdictions, is that the ISSB is the locus for a global baseline standard. That is reflected not only in the G7 work but also in the G20. The US is also very pragmatic about some of the limitations of standard-setting processes generally, and this one in particular.

There are three buckets of differences. One is the materiality versus double materiality approach. The second bucket concerns deciding whether to focus on investor protection aims or to use disclosures to achieve other societal aims. That comes in two buckets. There is the materiality bucket and whether to apply a taxonomy to the underlying disclosure apparatus. There are many jurisdictions, including the US, that are very unlikely to have a top-down activity-level taxonomy, be it applicable generally or to disclosures. Then there is the choice between whether to pursue climate versus all ESG. Finally, there is the significant fundamental difference in liability that attaches to the various disclosure regimes, where the US has a much more significant liability hook.

Given that reality, authorities may focus on how to achieve commonality in a few discrete areas. One of those areas may be transition plans. Most jurisdictions are not going to require companies to have transition plans. The question for those jurisdictions is how to encourage, rather than dissuade, companies from choosing to have a transition plan. Nascent transition plans could lack the methodological rigour or data necessary to make accurate public disclosures. Regimes that take that reality into account are likely to provide more valuable information to investors, while jurisdictions that do not are likely to have a chilling effect on the adoption of transition plans.

2. What should be done in the near future?

An industry representative stated the market needs reliable and high-quality data immediately. Some of these standardisation efforts are still in the early stages. For the ISSB, the climate part of the topics covered have been seen. This should move faster.

Some standards are voluntary, and some standards are mandatory, but the past has shown that it is making corporate ESG or sustainability disclosures mandatory for companies that leads to real progress. The ISSB needs to be encouraged to continue with its coordination efforts outside of the European Union for there to be mandatory reporting in other jurisdictions as well.

The materiality debate is important because the materiality perspective determines which topics are covered for specific sectors. If there is a pure financial materiality perspective, that limits the topics covered in a given standard. The ISSB giving more explanations on dynamic materiality is welcome.

Data users and providers of data insights and assessments need as broad a coverage of topics as possible. There cannot be a focus just on a few topics even if they are important, like they are for climate change. Entities are not only asking for climate data. They also ask for perspectives on human rights, labour rights, ESG and water consumption amongst others. One area to focus on is making the implementation as easy as possible for all participants. Market participants need clarity as far as is possible on what they have to do. This is particularly important for financial institutions as they are both users and preparers. There is difficulty using information when it is not similar to other information.

An industry representative noted the clarification work is quite technical and being done jointly by the standard setters in a co-construction mode. The financial impact of physical risk is needed for Pillar 3 reporting for banks under the Basel Framework, and there are typically very different ways of doing this so it is difficult for banks to use.

It would be useful to provide users with something that will tag the quality of the data. There is something in the International Financial Reporting Standards (IFRS) fair value levelling, for example, which will help people who are looking at the data to understand the quality of it and perhaps ease the tension in the discussion between regulators and market participants on the need to be exhaustive and reliable in the coverage.

An industry representative noted that there remains a real risk of fragmentation. There is a risk of double reporting, not just for financial firms but for all global firms. If each jurisdiction applies its own standards to internationally active firms and do so on a group basis without formally recognising the standards applicable in other jurisdictions, that would result in different rules, with different timelines and different legal bases. Then there will be issues of duplication and extra-territorial application of standards, unless there is a formal system of mutual recognition, determination of equivalence or some form of substituted compliance. If firms cannot apply substituted compliance, then what may be needed is a proportionality concept that will allow a third country firm operating in Europe to follow ISSB standards and still be compliant with the European system.

An official highlighted two challenges. One is a top-level threshold question. Although disclosure is vital, there is a risk of over-reliance on financial regulatory policy to the detriment of a focus on fiscal, tax and environmental regulation that may be more efficient and effective. With respect to disclosure in particular, one challenge concerns the potential for overlapping jurisdictions of various national domestic regimes. Overlapping jurisdictions may lead to a conflict of laws and perverse consequences for capital allocation. If the Corporate Sustainability Reporting Directive (CSRD) applies extraterritoriality, that may lead issuers to withdraw from the EU market if they have relatively narrow exposure to it. On the other hand, emerging markets have expressed concern that a jurisdiction-by-jurisdiction approach to reporting, rather than a business segment approach, may lead to a naming and shaming exercise that could result in different capital allocation outcomes and pull capital away from emerging markets.

A policymaker suggested the next big challenge is complying with the timetable. Assuming that is achieved there will then be the application of the framework from 2024. EFRAG is preparing the standards with usability in mind. As the standards are linked to policy developments, over time there will be a need to adjust the standards to still-evolving policies.

3. CSRD and convergence between ISSB and EFRAG

A policy-maker suggested this may be an opportunity to look at CSRD, which is the legal framework for the work on the standards in the European Union and that provides a comprehensive framework for companies' sustainability reporting. CSRD defines the scope of the companies covered and the dates of mandatory application. It also addresses third-country companies and assurance on sustainability disclosures.

The centrepiece of CSRD is a mandate for the Commission to adopt mandatory sustainability reporting standards that are prepared by EFRAG. These have to correspond to the double materiality principle. The aim is to avoid double reporting, which means the standards have to correspond, to the maximum degree, to international standards such as the ISSB standards. That should be done by integrating the content of the ISSB standards into the European Sustainability Reporting Standards (ESRS).

Double materiality is an important point where there is no global consensus, but the European standards should also be policy relevant and that is another difference between the ESRS and the ISSB's standards. That means that the European standards build on the EU acquis, which is not possible at the international level. The EU's key definitions of pollution, water quality and others have to be covered. The objective should be to make sure that companies that comply with the European standards also comply with the ISSB's.

An official highlighted two key elements to the EFRAG standard-setting journey. One was avoiding multiple reporting at all cost. It is fundamental to build on and contribute to existing standards. That is why cooperation with other standard setters and dialogue with others was established. The other key point is that it is better to pool resources and co-construct because ultimately everyone is short in terms of resources. The very detailed dialogue taking place between ISSB and EFRAG is extremely encouraging.

There are nonetheless some hurdles to jump over. One concern is when an impact becomes financially or enterprise-value relevant, because that is difficult to state and could be relatively subjective. Another is a timing issue. The standards developed by EFRAG have to comply with the CSRD as a standard setter. It has to deliver these standards to the Commission in November because the Commission itself has its own timing to adopt the standards. The ISSB will probably be put in the position of deciding slightly after Europe has, due to the political objectives, so the hope is that the dialogue will minimise what issues there may be.

The Chair noted the usefulness of sustainability reporting had not been questioned, which was not the case at roundtables held only a few years previously.

4. The issue of small and medium-sized enterprises (SMEs)

The Chair remarked that there is the issue of SMEs. That is probably strictly related to the static view of sustainability reporting, whether they are able to do so, whether it is meaningful for them to do so in exactly the same way or whether there is proportionality.

An official noted that G7 members explicitly requested that the global baseline be suitable for SMEs as well. SMEs need to have reporting options if they ask for financial investments or loans from the financial sector, so it could be in their interest as well to do their sustainability reporting. However, SMEs are quite vulnerable with regards to the costs of bureaucracy. It is key that SMEs have a chair at the table when it comes to the development of the upcoming standards in Europe and at the international level as well.

An industry representative remarked that there has been growing awareness among SMEs about ESG and the importance of ESG as a competitive advantage. It remains a problem to turn this into operational implementation. SMEs have limited means, and though many things are available in the ecosystem many SMEs are not aware of them. There is also a lack of direction on what they need to do, and fear that the upcoming CSRD regulation and the banking regulation for Basel Pillar 3 will pose a problem for them to access financing or contracts. CSRD and what is going to be proposed for SMEs will be very important, because having something there can be a very good accelerator and give a direction, provided it does not come too late and is not disconnected from what their value chain will ask for in terms of information. There is a need for the public authorities to provide support and give direction for what needs to be done, including helping to implement the reporting.

An industry representative stated the need for reliable, comparable, verified data with global coverage, including going into the SME sphere, is very relevant for financial institutions, be they banks, insurance companies or investors. There are entities with large, broad investment portfolios. Some are very specialised. There are many different use cases, and not everyone is asking for the same type of data. As broad a perspective as possible is needed in order to be able to collect that data, and deliver it in various forms. Some entities sought raw data, some want an opinion overlay with the scores and assessments, and then others want data mapped to various different standards and labels. Banks and insurance companies are increasingly obliged to integrate ESG factors into their risk assessment, and they see challenges with physical risk.

On the climate side, the data and modelling is becoming better but biodiversity, which is such a huge, important and threatening topic for humanity, is very hard to quantify, very hard to measure and very hard to understand. The Taskforce on Nature-related Financial Disclosures (TNFD) just identified more than 300 different types of assessments for biodiversity impacts and dependencies. There is a need for clarification on that front as well.

5. Transition plans: a possible game-changer

An industry representative confirmed there is a positive development in that the ISSB's proposed framework includes the disclosure of transition plans, which is an important step for advancing the low-carbon transition. However, though disclosure is necessary it is not sufficient to achieve the goal, and transition plans have to be credible and globally comparable. For financial institutions, it has to be ensured that client firms are eligible for transition finance, which will be critical for that firm to successfully implement its transition plan.

Emerging markets need the money to transition. All of that money cannot come from the official sector. Private capital needs to be mobilised, and there again is the question of how to make sure the transition plans of those countries, not just at the country level but at the firm-by-firm level, are credible and justifiable in terms of any additional finance provided from Europe, the US or Japan.

Another element is to make sure that those transition plans are credible at the client level needed to engage those clients. Publicly available information is not sufficient. There is a need to go in-depth, have real engagement with the clients and make sure that they understand why the bank is not just asking for more information, and also to perhaps be critical of their transition plan draft, and make sure the bank assists in upgrading whatever draft transition plan there is with that client. This will also apply in the emerging market context.

The official sector or public authorities should recognise the importance of transition finance based on credible transition plans, and the regulatory framework should not disincentivise such activities by banks.

An official explained that transition plan disclosures are a very important part of the package of the ISSB proposals, to ensure investors understand the consequences in terms of what is coming ahead for a company as a result of climate change and other sustainability risks. This is also an opportunity for companies. If an entity can present a credible transition plan, it can potentially attract capital for those who want to invest in those industries.

The other area the ISSB proposed in the exposure draft is more specifically on the planning for carbon emissions targets or carbon reductions targets. There will need to be consideration of the feedback and probably a strengthening of that area somewhat, to make it clearer that carbon reduction strategies are very important separately from stating what carbon offsets an entity is using, and also making sure there are good disclosures around what the carbon offsets are and the credibility of people's plans. The desire is for people to be able to examine carefully whether these transition plans are credible, so capital is allocated in the right places. One area where the proposed disclosures could be brought somewhat closer to what EFRAG has proposed is on the transition plans front.

An official confirmed the importance of transition plans because aesthetic vision plus a long-term commitment without the definition of a trajectory and the milestones that go with it does not create the right level of credibility. The gross/net issue can be solved. There are policy references in the EU and people expect information about the direction of travel and the speed to the destination.

The Chair recounted an occasion some years ago with students who stated they were carefully examining the sustainability reporting of French corporates. France was one of the first countries to introduce such reporting. This was to check whether they could work in those corporates or not, and whether they wanted to be hired by them or not. They were the first to express that the reporting was useful.