EU SUSTAINABILITY FRAMEWORK

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ISSB Strategy Lead- International Financial Reporting Standards (IFRS) Foundation

Towards global consistency – Interoperability between ESRS and ISSB Standards

The International Sustainability Standards Board (ISSB) was formed to develop – in the public interest – a comprehensive global baseline of high-quality sustainability disclosures to meet investors' information needs. The European Commission had already embarked on developing its Standards - the European Sustainability Reporting Standards (ESRS) - before the ISSB was established. Bearing in mind investors' need for consistent and comparable information, as well as to limit the burden and costs for companies, interoperability between ESRS and ISSB Standards is of the utmost importance.

Reliable, rigorous and easily comparable information is a vital prerequisite for the effective functioning of the capital markets. So too is the requirement for investors to have access to material information necessary for a comprehensive analysis of companies' risks and opportunities. Sustainability factors have quickly become a crucial part of mainstream investment decision-making.

ISSB Standards have been developed as a direct response to this need for sustainability disclosures. ESRS have been developed with a complementary yet broader mandate. ISSB Standards focus purely on providing relevant information to investors, with the ESRS having an additional aspect to meet European public policy goals – financially material information is a common and shared goal.

Work undertaken by the ISSB, EFRAG and the European Union has successfully led to a high degree of alignment between the respective sets of standards, reduced complexity and duplication for companies who will apply both the ISSB Standards and ESRS.
Detailed work has been undertaken to map how a company can apply both sets of standards to reduce duplication, with publication of interoperability guidance due in the coming months. We are regularly reminded of the importance of this work from key stakeholders; and the importance of it being available to companies as preparations are made to report based on both European and international standards.

The interoperability guidance will highlight common disclosures between the respective requirements and those that can be aligned when particular choices are made, for example applying the Greenhouse Gas Protocol. Beyond this, the digital tagging of the disclosed information will be an important tool.

Work on interoperability will not conclude upon publication of the interoperability guidance. It is going to be vitally important that European and international standard setters continue to work closely together as the ISSB begins its work beyond climate and as European sector standards are developed.

Companies will be able to collect, govern and control decision-useful data once, and then determine which data is material information for different stakeholders, reducing duplication.

A determined effort has been made to reduce complexity and fragmentation; and to remove barriers to comparability that might have undermined the usefulness of sustainability information in decision-making. ESRS and ISSB Standards aim to use the same language and definitions for disclosure requirements; and the same metrics where they are designed to address the needs of investors.

This collaborative approach to interoperability has extended to the mapping of each paragraph of IFRS S2, the ISSB's climate-related disclosure standard, to relevant paragraphs in ESRS. For matters other than climate, reciprocal references mean ISSB Standards refer to ESRS as a source of guidance to identify what information to disclose, to the extent it meets investor information needs. Equally, ESRS refers to ISSB industry-based guidance.

In 2024, the ISSB will continue to dedicate itself to working closely with regulators as they consider pathways to adopting the ISSB Standards; and we'll be supporting companies and investors to build capacity for this new reporting landscape.

As jurisdictions around the world make progress to introduce the ISSB Standards as a global baseline, European companies will be better prepared to meet disclosure requirements at home and abroad. This has important benefits. Thousands of European companies have value chains in jurisdictions that have already announced their intention to adopt ISSB Standards. The use of these international standards will ensure the reliability of the auditable data derived from them, which will be of particular value, for example, when European companies are required to report Scope 3 emissions to comply with ESRS.

The high-degree of interoperability between ESRS and the ISSB Standards is a shared success. But it is an ongoing process as the world continues to move towards being able to measure – and therefore truly value – sustainability.

GEORGE THEOCHARIDES
Chairman - Cyprus Securities and Exchange Commission

Sustainability at the heart of the EU capital markets

Sustainable finance and digitalisation have already made a deep impact in the EU capital markets and they will continue to drive the reshaping of the financial regulatory landscape for years to come - building upon the momentum seen in the last decade.

Regulation aimed at combatting greenwashing has been ramped up and will remain a key feature in 2024. For Europe, more detailed disclosures from firms will be required, and ESMA's ruling on the use of ESG related terms in fund names is also to be finalised.

In the UK, the FCA published its final rules on ESG investing and greenwashing rule and the US finalised its ESG investing rules and released the final versions of its climate risk disclosure and cybersecurity risk governance proposals, as well as new proposals related to human capital management and board diversity disclosures.

Implementation of sustainability standards

It is the role of regulators to identify future trends and to anticipate the potential risks and unintended consequences – and the known knowns. This means that not only do we need to keep pace and move swiftly to protect investors from new and emerging risks, but we are also harnessing technology to drive innovation that increases the efficiency of our own operations.

This commitment revolves around upholding high standards of investor protection and confidence, while simultaneously fostering the healthy growth of the market with the introduction of new products and services. The rational for ESG investment is that if capital is deployed in companies which represent positive trends for the benefit of mankind and engage in ethical and sustainable business practices, more companies will adopt these policies. Over time, the lower cost of capital will enhance their investment returns, whilst growing demand for their products and services and sound labour relations will contribute to a stronger operating performance. Hence, ESG investment is seen to achieve relatively strong investment performance, whilst supporting 'good' businesses relative to the pure pursuit of profit.

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The European Securities and Markets Authority (ESMA) has proposed new rules on using ESG or related terms in the names of investment funds. Under this proposal any fund that has any ESG or related term in its name, must have at least 80% of its investments supporting ESG characteristics, with an additional threshold (50%) if the fund is using sustainability, meaning that at least half of the 80% threshold should be in sustainable assets under SFDR.

The UK's FCA has outlined its SDR proposal, which is proposing to introduce three labels for sustainable investment products: Sustainable Focus (products investing in assets that are environmentally or socially sustainable); Sustainable Improvers (products investing in assets to improve the environment or social sustainability over time, including in response to stewardship influence of the firm) and; Sustainable Impact (for products investing in solutions to environmental or social problems to achieve positive, measurable real-world impact).

The FCA is also proposing more detailed disclosures in order to help consumers understand key sustainability features of products, as well as restrictions on how certain sustainability related terms can be used in product names and marketing for products that don't qualify for these sustainable investment labels.

In the US, the MSCI has changed the methodology behind its fund level ESG ratings, which is resulting in a one-time downgrade of approximately 31,000 funds. These raise the requirements for a fund to be classified as AA or AAA, improve stability in fund ESG ratings, and add transparency.

Technological innovation

Regulators have a need to understand the challenges to financial markets posed by the growth of technology, in all its forms and be ever vigilant to the new and emerging risks. Amongst these is the rise of retail activity and increased market accessibility, which has led to aggressive marketing practices as well as false claims which include "greenwashing", practices that give consumers the impression that the product or service they are using prioritises ecology and green initiatives. CySEC's own monitoring of the market has shown that the number of fraudulent advertisements has increased dramatically, with young investors now the most vulnerable to potentially overly aggressive marketing strategies. These emerging challenges related to technological innovation are expected to be addressed through new legislations that are under the way.

CARLO COMPORTI
Commissioner - Commissione Nazionale per le Società e la Borsa (CONSOB)

Opportunities and challenges of the new sustainability reporting requirements

The EU has been at the forefront of shaping corporate sustainability practices through Directives on sustainability reporting.

The Non-financial Reporting Directive (Dir. 2014/95/EU or NFRD) applicable since 2017 marked a significant step in requiring large companies, particularly public interest entities, to report non-financial information. However, challenges arose, limiting its effectiveness, particularly in terms of completeness and comparability of information provided to the market.

The recent Corporate Sustainability Reporting Directive (Dir. 2022/2464/EU or CSRD), applicable to reporting years starting from January 1, 2024, aims to address these issues and marks a significant progress in the evolution of the sustainable reporting framework. The remainder is focused on what may be considered the three primary advancements.

Firstly, the CSRD is explicit in requiring entities to disclose information to allow investors and stakeholders to understand the impact of companies on people and environment and to assess financial risks and opportunities arising from climate change and other sustainability matters.

Secondly, the CSRD specifies the content of the sustainability report directly in legislation and entrusts the development of reporting standards to a single standard setter, EFRAG, so as to ensure that the standardization of information promotes completeness, accuracy and greater comparability of sustainability data.

Thirdly, the CSRD underlines the importance of linking financial and sustainability information and, by doing so, it aims to provide a holistic view of a company's operations, offering stakeholders a more integrated perspective.

The new priority is to support companies to adapt to the new requirements.

This significant progress does not come without challenges:

1. The double materiality test, which is at the core of sustainability reporting, is far from being straightforward. When identifying the sustainability matters and information to be disclosed, companies have to assess both impacts on society and environment (impact materiality) and impacts on company's performance, financial position and cash flow (financial materiality), albeit such double materiality test is complex to perform. Among other difficulties, it involves the engagement of many stakeholders and requires the use of non-financial metrics related to ESG aspects. These metrics often lack standardization and makes it difficult to establish consistent benchmarks across different industries.

2. Granularity of information required by reporting standards is another area of difficulty. Gathering detailed data across the organization can be a complex task, especially when dealing with diverse business operations.

3. The third and most prominent challenge lies in the substantial increase in the number of companies that will be subject to CSRD and the expanded reporting contents. At EU level we expect to move from 11.600 companies subject to NFRD to more than 50.000 companies directly impacted by the CSRD. The expanded reporting contents mandated by CSRD and ESRS (European Sustainability Reporting Standards) may pose a significant burden on companies, especially smaller ones, as this will require significant investments to adjust internal processes and systems to the new requirements.

Even more important is that the number of companies indirectly impacted may be significantly higher than estimated, as CSRD requires companies to consider the impact across their entire value chain. This approach means that not only large public-interest entities, but also small and medium enterprises (SMEs) will be required to disclose sustainability information.

The new reporting requirements embed some degree of proportionality, since for listed SMEs the set of information is more limited and the reporting obligations will have to be complied with following a phased-in approach. Although unlisted SMEs and micro-enterprises are excluded from the scope, EFRAG is developing an ad-hoc voluntary standard, taking into account that such companies are indirectly involved in the reporting process because, often, they are part of the value chain of large companies.

Ensuring that SMEs possess the necessary capabilities to understand the new reporting framework and provide meaningful ESG information remains an important challenge. Collectively, we need to support SMEs in the sustainable transition. Across the EU, governments and policymakers are launching various initiatives with the specific goal of supporting SMEs in their sustainable practices, with a view to enhance their ESG reporting. These initiatives include targeted educational programs designed to raise awareness among SMEs, as well as the facilitation of collaborative platforms that bring together SMEs and sustainability experts to enable the knowledge sharing.

Now that the reporting framework has been finalized or almost finalised, the new priority is to support companies to adapt to the new requirements, which is paramount to achieve high quality reporting and, ultimately, fostering sustainable transition.

SACHA SADAN
Director of ESG - Financial Conduct Authority (FCA)

Creating the ecosystem for reliable sustainability data

From regulators to international bodies, stakeholders are closely examining how to collect reliable sustainability data while simultaneously developing methods to disclose this data in a simple way. Historically, traditional methods such as corporate reporting have been central to collecting sustainability data. However, the ESG sector has quickly developed in the last few years and innovative data collection tools, such as transition plans are opening the door for new datasets. We see forward looking data as an essential instrument to solve systemic issues and at the FCA, we are thinking about data and how best to support market participants navigate their sustainability journey.

As we regulate firms that span across many jurisdictions, we want to support them and by being consistent with international frameworks and standards as far as possible, as we believe in global solutions to global problems. We also believe that it's important to hold firms to account as we expect the data to be credible and so do investors.

Implementing regimes that promote comparable data is necessary to broaden the scope of sustainability data available. To support this, we have been early advocates of the International Sustainability Standards Board (ISSB) and its goal to create a common baseline of sustainability reporting standards. We look forward to the standards being launched this year. In the meantime, we welcome the UK Government's work to establish a process to review and endorse the standards for use in the UK while at the FCA, we hope to consult on updating our climate disclosure rules to refer to the ISSB standards.

It cannot be understated that trust in numbers is vital as such we welcome another milestone from December 2023; the International Auditing and Assurance Standards Board (IAASB) consulted on their proposed International Standard on Sustainability Assurance (ISSA) 5000, General Requirements for Sustainability Assurance Engagements. This is the first step on a long journey to a baseline sustainability assurance standard.

Furthermore, the sustainability journey is based on outcomes for the future in which transition plans are a pivotal tool for forward-looking data. Transition plan disclosures can provide transparency in the market by increasing the availability and credibility of sustainability-related information provided to investors when assessing a firm's future prospects. Data from these plans can enable the markets to function more effectively, for example, corporate transition plans can inform capital allocation decisions and investor stewardship. Transition plans are an important factor in identifying the firms that are walking the walk.

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The FCA is an active member of the Transition Plan Taskforce (TPT) which launched its Disclosure Framework and Implementing Guidance in October; the TPT supports the scaling up of transition plans by encouraging material, robust and comparable forward-looking information to be adopted in the plans. Additionally, we intend to consult in 2024 on disclosure requirements based on the ISSB standards and TPT Disclosure Framework as a 'complementary package'.

Additionally, we are examining how to improve traditional backwards looking data in the ESG ratings space by increasing availability and quality of forward-looking data. We also think a ratings user should be able to distinguish from what data is backwards looking versus forward. Technology and digital innovation can help address this and scale up the availability of sustainability-related data whereby the data from transition plans should also remedy concerns by integrating forward looking information into a rating score.

A key focus at the FCA is ensuring the credibility of sustainability-labelled finance instruments and products. Sustainability data needs to be accessible in clear and simple terms, to be able to be understood by consumers and build their trust in the market. We recently launched our Sustainability Disclosure Regime (SDR) which provides for a consumer-driven framework to simplify and help navigate the complex sustainability investment landscape by presenting sustainability claims from funds in a clear and not misleading manner while highlighting key KPIs in two pages.

It is also important to take advantage of what other players across the world are doing. For example, it is necessary to provide a central point to increase the accessibility of data, we have been supporters of the Net Zero Data Public Utility (NZDPU) as a free tool to help increase the transparency of climate data in the transition by centralising data from a variety of different sources.

Each stakeholder has a role in ensuring that sustainability data is available. Global public actors must provide organisations with the tools and frameworks for reporting and disclosures, while firms need to ensure their data is reliable and accessible. We recognise that this is a long-term journey that will continue to develop as the green transition progresses.

DANIELA MARILUNGO

Head of International Public Policy - Bank of America

Fulfilling the promise of sustainability data

The EU's 2018 Sustainable Finance Action Plan recognised the promise of high quality sustainability data as a means of driving Europe's transition to climate-neutrality. There has been significant progress since then on advancing the requirements for non-financial reporting, leading to a more consistent and comparable disclosure framework. This will in turn facilitate the allocation of capital to initiatives that accelerate the transition to net zero and realise the ambitions of the European Green Deal. But there is still more to do, not least improving the availability of data from smaller companies.

The development of the European Sustainability Reporting Standards (ESRS) means the EU has now put in place a comprehensive reporting framework. Their development has happened at pace, and the outcome is a full suite of standards across environmental, social and governance issues. Once fully embedded in the non-financial reporting framework, they will provide what is effectively a self-policing mechanism for ~50,000 companies in Europe. The powerful tool of transparency will allow a light to shine on business strategies and practices across the economy.

Of course the ESRS do not come without challenges. The implementation and application of the standards is an onerous process, not aided by their breadth, their extra-territorial reach, and the need to apply judgement which will inevitably lead to varying approaches across sectors. The ESRS also require double materiality assessments – i.e. not just how the business is affected by sustainability issues, but also how their activities affect the outside world – which implies an added level complexity for reporting entities.

In parallel to the EU standards, the ISSB has developed its own, narrower, set of standards that offer a baseline for adoption globally – IFRS S1 and S2. In contrast to the ESRS, the staged approach taken by the ISSB means the initial focus is on climate disclosures only, with further environmental, social and governance standards in the pipeline. Critically, there is no requirement for a double materiality assessment – marking one of the principal differences with the EU's approach.

A growing number of jurisdictions across the planet – including major economies – have already expressed their support for the ISSB standards, signalling their intent to adopt them in the near term. Considering it took nearly two decades for the adoption of the IFRS accounting standards, the race is on to achieve a similar (or better) adoption rate in five years or less.

When taken together, the ISSB standards and the ESRS promise the replacement of a patchwork of voluntary reporting standards, which adopt often very different approaches, with a more consistent and inter-operable set of mandatory standards. The consequence will be easier comparability, and a non-financial reporting framework that is much more akin to its financial reporting equivalent.

Further progress will however be hindered by the limited coverage of the requirements. The European Commission intends to develop a set of separate standards for listed SMEs, while encouraging unlisted SMEs to adopt them voluntarily. But the level of overall coverage of the mandatory standards means that there is a greater onus on voluntary adoption and/or market-based solutions to fill the 'data gap'.

Data aggregators are seeking to offer value-add products, but fundamentally their offerings are held back by a lack of data availability. Simply put, not enough companies are producing the data that is needed. So how can we address this without over-burdening smaller companies with onerous requirements, given their more limited means?

The private sector is already responding to this challenge, with financial institutions weighing up the best way to collaborate on solutions to ensure there is sufficient data available on smaller companies. The Net-Zero Public Data Utility – backed by GFANZ – also offers encouragement. Its mission is to provide "a trusted, central source of company-level climate transition-related data that is transparent and openly accessible to all". In December 2023, it unveiled a proof of concept, illustrating the potential of the initiative.

There is still more to do, not least improving the availability of data from smaller companies.

Policy-makers can help too. The European Commission can utilise its tri-annual reviews of the ESRS to further refine the standards, minimise their burden on in-scope entities and deliver greater alignment with international standards. Global advocacy to boost the adoption of the ISSB standards will also help. As will efforts to refine existing green taxonomies and develop internationally consistent taxonomies so that there is common understanding of what constitutes 'green'.

We can take heart from the progress made in recent years, while acknowledging that a further push is still needed. Fulfilling the promise of sustainability data in contributing to the transition to a net zero economy will require a joint effort from the public and private sectors.

CORNELIA ANDERSSON

Groupe Leader, Sustainable Finance and Investment - London Stock Exchange Group (LSEG)

Deliver on net zero targets: 5 principles for ESG data to support the transition

Global capital markets are a complex environment. Whether asset owner, asset manager, broker, investment bank or consultant, resources are limited, and difficult decisions need to be made as to where to commit capital. Those decisions are first and foremost rooted in good quality data.

Reliable information is critical to help investors and the broader ESG stakeholder community to look past the public messages and the hype. Investors need effectively to understand the reality of corporates' climate-related risks and opportunities, to ultimately efficiently allocate capital and manage risks in a sensible way.

Despite the clear need for robust and transparent data, good ESG quality data is still missing.

As an example, scope 3 GHG emissions data is not only still scarce, but also very volatile when reported. LSEG's research concluded that half of the corporate reported scope 3 values variated by 20% year on year, and a third by 50% (up or down). This volatility can have a knock-on effect on the effectiveness of climate benchmarks and related ETFs, among other financial products, as it creates uncertainty and risk that disincentives the use of those metrics by investment professionals.

Fortunately, the adoption of regional or global standards for sustainability reporting (European Sustainability Reporting Standards (ESRS) in the EU, International Sustainability Standards Board (ISSB)) globally) represents major progress for sustainable investment.

Policymakers should now focus on implementation and support to corporates to improve data availability and quality.

In order to ensure good quality data, standard setters and regulators should follow 5 key principles:

- First, data should be available: although the EU has been a first mover with the adoption of the CSRD, the rest of the world is yet to catch up. This is why LSEG supports ISSB's call for global adoption of its sustainability and climate-related standards ("S1" and "S2") by 2025, across the globe and across market segments, be they public or private.

In order to ensure good quality data, standard setters should abide by 5 key principles.

- Second, data should be reliable, as per the scope 3 example above. Assurance or audit processes can help. However, in order to be effective, assurance should be rolled out progressively and in a coordinated manner, to ensure sound capacity building in this new field. IOSCO should define global principles of assurance and audit of ESG data to support regional policymakers' efforts. Reliability also warrants a certain level of simplification, or at least a focus on key proxies that provide insights into a corporate's management of sustainability risks. Detailed reporting can lead to too much noise, blurring a corporate's actual performance or exposure to ESG risks.
- Third, comparability is key to good quality data. Capital markets are global and so is climate change. For ESG data to be usable and contribute to an effective net zero transition, there must be absolute clarity on the interoperability of ESG standards frameworks. If full alignment is not achieved, then at least indicator-level mapping between the various frameworks is needed.
- Fourth, usability is critical. This requires global coordination in digital tagging. Granularity and consistency in digital reporting (e.g. XBRL) means that identical data points under ESRS and ISSB should have the same digital tags, even though the frameworks themselves are not entirely identical. Digital tagging coordination would facilitate rapid collection and, ultimately, integration of ESG data in investment decisions by the financial sector.
- Finally, policymakers should strongly care about corporates' capacity building and preparedness. Private institutions and public institutions should work hand-in-hand on this matter. Companies like LSEG, which operate across the lifecycle of global capital markets, can partner with standard-setters. By leveraging our industry's platforms, policymakers can further amplify their voice and support to the financial and economic community, from investors to issuers, from brokers to regulators. This is especially true for standards with a global or extraterritorial reach, where global corporates are less familiar with regional developments.

Having those principles rooted in the implementation of ESG standards frameworks is central to a successful delivery of both EFRAG and ISSB work and ultimately to the effective integration of sustainability considerations in investment and lending strategies. We need the right foundations to start delivering on the net zero journey and are committed to support the general transparency effort.