CHALLENGES FACING THE EU SUSTAINABILITY APPROACH

JEAN-PAUL SERVAIS
Chair - International Organization of Securities Commissions (IOSCO)

Global challenges in the international sustainable finance framework

Global progress towards the introduction of sustainability disclosure requirements has been swift since IOSCO announced its endorsement of the first ISSB Standards in July 2023.

IOSCO called on its members, who regulate companies in more than 95% of the world's financial markets, to consider ways in which their jurisdictions might adopt, apply or otherwise be informed by these ISSB Standards within the context of their jurisdictional arrangements.

The ISSB can now count on a growing number of jurisdictions that have taken steps to integrate these standards into their regulatory regimes.

Currently, these jurisdictions together already account for almost 55% of global GDP, more than 40% of global market capitalisation and above 50% of global greenhouse gas emissions.

Thousands of companies around the world are now preparing for the publication of their first report for the 2024 end of year accounts. We estimate that up to 130,000 firms could use the ISSB Standards or aligned disclosures in due course.

The public sector acknowledges the implementation challenges and costs for companies, as well as what some have called the emergence of sustainability fatigue. However, the benefits of sustainability reporting outweigh the costs, and it may well be that soon the entities that do not join the sustainability reporting may incur an added cost.

In this respect, it is important to highlight that some jurisdictions will phase in the new requirements over time. Other jurisdictions are expected to follow a climate-first approach, in some cases as a step towards a more comprehensive approach to adoption at a later point. Jurisdictions may also scale up requirements gradually, starting with certain industries or a subset of listed entities.

As companies around the world are increasingly mandated by the ISSB Standards and the ESRS to disclose sustainability-related information, EFRAG and the ISSB have taken welcome steps to reduce complexity, fragmentation and duplication for companies applying both the ISSB Standards and ESRS.

To encourage convergence and interoperability of sustainability reporting regimes, IOSCO will continue to focus on and dedicate resources to implementation and capacity-building, particularly for many emerging markets. This is important because these emerging markets are the same jurisdictions that are both in need of capital market funding to finance the climate transition and that will require the most assistance in implementing sustainability reporting standards. It is therefore a priority for IOSCO to support jurisdictions in their implementation considerations of disclosure requirements within their own domestic contexts, in line with IOSCO's endorsement decision.

Recently, IOSCO has begun to work on transition plans, another piece of the ESG data puzzle, as these are seen as important in providing key information to investors and financial markets. Transition plans are relevant to investors and the market only if they allow for comparison, are consistently reported and of high quality. Otherwise, they could increase the risks of greenwashing, which leads to the erosion of investor trust. This is why we believe collaboration at international level is necessary, to mitigate the risks of fragmentation by working together. IOSCO has a role to play to prevent a new alphabet soup of voluntary transition plans and disclosure initiatives, in the best interest of issuers and investors.

To contribute to the trustworthiness and thus usefulness of the disclosures, IOSCO also encourages the global development of assurance standards. The current landscape in this regard is very heterogeneous in terms of the scope of the assurance and who provides the assurance. In order to maximize trust and confidence in sustainability disclosures, both investors and markets expect that high-quality assurance over sustainability reporting should be required on a global scale. In this respect, we are engaging with the international standard setters on their forthcoming assurance standards, to assess if IOSCO can encourage its members to take them into account as they consider assurance in their jurisdictions.

To conclude, it should be recognised that the sustainable finance regulatory framework, at both global and EU levels, has been created at exceptional speed, given the complexity of the matter and all the elements of the investment chain it covers.

To avoid regulatory fatigue, the focus is now on stabilizing and converging the regulatory framework at international and European levels and on devoting due attention to the implementation phase.

LUCA FERRAIS
Director, Sustainable Finance and International Affairs – Ministry of Economy and Finance, Italy

Streamlining ESG: regulatory simplification and technological innovation

The path to sustainable finance is complex and multifaceted, requiring a careful balance between regulation and competitiveness.

The debate over the best approach for sustainability focuses on market-led initiatives, which encourage voluntary adoption of sustainable practices through market incentives, and formal transition policies, which mandate these practices through regulations. Market-led approaches foster innovation and flexibility, as seen in the growth of green bonds in Europe, while formal policies ensure minimum standards and prevent "greenwashing." Both approaches aim to integrate sustainability into business practices, balancing innovation with accountability.

Recent opinion trends and political developments suggest that while robust regulation remains important, there is a growing need for simplification and adaptation to support a business-friendly environments. Regulations that are too rigid and complex can lead to compliance fatigue, where businesses, especially SMEs, become overwhelmed by the administrative burden of adhering to numerous and frequently changing technical requirements. This fatigue can result in diminished engagement with sustainability initiatives and potentially higher operational costs and competitive disadvantage.

There might be a possible shift from a transparency-focused sustainability approach to one centered on risk mitigation, regulatory simplification and enanched digital solution. This shift may require a renovated focus on:

1. **Usability and renewed balance of existing frameworks:** A review of current rules to address inconsistencies, simplify processes, and ensure proportionality, especially for SMEs, is essential. This could involve consolidating overlapping definitions and streamline technical requirements across sectoral legislation (i.e. banking, investment funds, insurance, non financial). This can be achieved also through dynamic principles-based regulations tailored to specific sectors that set clear objectives but allow businesses the flexibility to determine how best to achieve them. There may be also a shift towards measuring and managing the actual impact of sustainability initiatives rather than merely focusing on transparency. This could involve developing new metrics and standards to assess the real-world outcomes of ESG efforts and ensuring that they contribute to broader sustainability goals.

2. **Innovative technologies**: Collecting reliable ESG data is a significant challenge. Companies must often rely on third-party data providers, which can vary in terms of methodology and quality. Making ESG raw data readily available and comparable for all stakeholders is key. It is pivotal to work on a centralised and effective management system, that should be publicly managed given the nature of public good of these data. The forthcoming creation of the European Single Access Point represents a promising tool for Europe. Similar initiative should be carried out with reference to raw data on ESG risks. In addition, advanced technology, particularly fintech solutions, plays a pivotal role automating data collection and reporting, improve accuracy, and providing real-time insights into sustainability performance along the supply chain, making it easier for businesses to comply with regulations and for investors to assess ESG risks and opportunities. By leveraging AI-driven platforms or cloud computing for example, both financial institutions and SMEs can enhance their sustainability performance while remaining competitive.

Regulatory balance and tech innovation are key to advancing sustainable finance.

3. **Collaborative Approaches**: Collaboration between policymakers, financial institutions, and other stakeholders will be crucial to developing effective and pragmatic sustainability solutions. This could involve public-private partnerships and multi-stakeholder dialogues to share best practices and drive innovation. In Italy we set up a Sustainable Finance Platform at the Ministry of Finance, involving the Ministry of the Environment and Energy Security, the Ministry of Entrepises and our financial supervisors. The Platform aims to be a forum for interaction and open dialogue between public institution and various stakeholders (public and private ones) and it is offering tools and solutions to promote and ease to private investment in sustainable projects.

By fostering an environment that supports both compliance and innovation, policymakers can drive a sustainable transition that is both effective and economically viable. Addressing ESG fatigue requires a balanced approach that includes clearer rules, better data management practices, and support for companies, especially smaller ones, in navigating these requirements.

SUZANNE LLOYD
Vice-Chair – International Sustainability Standards Board (ISSB)

Equipping investors with decision-useful sustainability information

Three years ago, the IFRS Foundation – the independent global standard-setter for the capital markets known for developing a global accounting language – announced the creation of a new standard-setting board: the International Sustainability Standards Board (ISSB).

The ISSB's task is to develop a global baseline of sustainability disclosures to meet investors' need for high-quality, comparable information about companies' sustainability-related risks and opportunities.

One important motivation for creating the ISSB was harmonisation in the sustainability reporting landscape. The fragmented landscape made it complex and costly both for companies seeking to provide sustainability information and for investors relying on that information and seeking to compare investees.

Three years on, the landscape of sustainability disclosures looks very different to 2021. The so-called 'alphabet soup' of frameworks, standards and reporting initiatives has been significantly reduced and jurisdictions around the world are incorporating sustainability-related disclosure requirements in their regulatory and legal frameworks. Investors will get the information they need to make informed decisions.

Embedding the global baseline

In June 2023, we issued our first two sustainability disclosure Standards – one covering general sustainability-related disclosure requirements and one setting out climate-specific disclosure requirements.

More than 20 jurisdictions around the world, representing over 50% of global GDP and global greenhouse gas emissions, are already taking steps to adopt or use the ISSB Standards with reporting beginning as early as [2025].

In Europe, the European Sustainability Reporting Standards (ESRS), developed by European standard-setter EFRAG, require European companies to report on sustainability matters from this financial year.

The ISSB's goal is to inform investor capital allocation decisions through globally comparable, targeted and decision-useful disclosures. The EU requirements also seek to meet various policy objectives, so require additional disclosures. While the EU and ISSB have different objectives, there is a high level of alignment in the Standards, particularly in relation to climate. This matters – especially for companies that are required or choose to use both sets of requirements.

To help companies navigate between the requirements, the IFRS Foundation and EFRAG published interoperability guidance earlier this year, providing practical materials explaining how companies can efficiently comply with both sets of standards.

The next chapter

The ISSB recently embarked on a new two-year work plan with clear priorities, informed by public consultation, to strengthen and build on the foundation created by our first two Standards.

The main priority is continuing to support the implementation of those Standards. We recognise that providing sustainability disclosures is a new territory for many companies, requiring upskilling and system changes.

Another priority is enhancing our SASB Standards – resources supporting companies in providing industry-based disclosures – and starting two new research projects, which could result in future standards. One project is centered on the risks and opportunities associated with biodiversity, ecosystems and ecosystem services. The other on human capital, including employees and workers in the value chain of a company. As with our first two Standards, our work in these two topic areas will consider building on existing materials, rather than starting from scratch.

> **Global sustainability disclosure landscape shaping up.**

The ISSB has identified three core activities that underpins all our work. First, ensuring connectivity between sustainability-related disclosures and the information reported in financial statements. Second, engagement with stakeholders and continued work with jurisdictions. And third, our work with other standard-setters – the Global Reporting Initiative (GRI) and EFRAG – to reduce fragmentation and duplication in reporting where possible - one of the reasons for creating the ISSB.

Collaboration is key

The ISSB continues to work closely with investors to understand their information needs. We've been encouraged by the strong investor response to our work already – investors have called for voluntary use by companies of the ISSB Standards, responded to jurisdictional consultations, provided feedback directly to us and been strong advocates for regulatory adoption of our global baseline.

We look forward to continued collaboration in our new phase of work – over the next two years and beyond.

LINDA-ELING LEE
Founding Director and Head of the MSCI Sustainability Institute – MSCI

Transition finance needs to reach beyond the boundaries of Europe

Capital is a prerequisite for decarbonizing our economy and so is policy. Nowhere is this more evident than in the European Union, where policy and capital are together driving progress. Emissions from electricity generation in the EU are set to fall by far more than any other region, according to the IEA. Earth's climate, however, is global, and progress remains uneven.

A greening EU in a brown world

Companies in the EU outperform the rest of the world in their decarbonization journey. Our data shows that 14% of EU-domiciled companies are "aligned to a net-zero pathway" (according to the Paris Aligned Investment Initiative's framework), compared with 3% outside the EU. While a majority (58%) of companies in the EU are still "not aligned" with a net-zero pathway, that compares favorably with 88% of listed companies elsewhere.

This success means EU companies now represent a dwindling share of the world's emissions. Global emissions are increasingly fueled by the Asia-Pacific region, which accounts for more than three-quarters (78%) of global coal-power generation capacity. Stemming climate change depends on investors' willingness to transition emissions-heavy assets in jurisdictions that may be far from their own.

The unevenness of the transition should be instructive for decision makers in finance and policy alike, as climate finance evolves from aligning portfolios with climate ambitions toward achieving decarbonization in the real economy. "Transition finance" marks this shift and should be guided by data showing where we are making progress and where we are not.

The data shows two growing chasms for transition finance to bridge: one between European companies and the rest of the world; another between the emissions associated with financial institutions' portfolios and the physical emissions of the economy.

Financial portfolios' emissions diverge from the real economy

Financial institutions are reducing the emissions they finance, yet overall company greenhouse gas emissions remain near record highs. That's because climate-focused capital is chasing a dwindling number of fast-decarbonizing companies that represent a fraction of global greenhouse gas emissions. To illustrate, an investment strategy designed to track a Paris-aligned benchmark must, by EU regulation, reduce average emissions by at least 7% annually. That means only 32% of the original investment universe of global companies are eligible; and for emerging markets, only 28%.

Data suggests that such strategies have had limited impact on economy-wide decarbonization so far. Further, an investment portfolio or lending book that decarbonizes much faster than the real economy risks becoming concentrated and less diversified over time.

Transition finance needs to go where the emissions are, and that's increasingly beyond the EU's borders

The movement to define and measure transition now sits at the crossroad of two camps. One takes a broad, inclusive view that every company should produce a transition plan. Transition capital flows to those with better plans. But the history of tying capital flows to better corporate disclosures and sustainability performance suggests that this will favor large companies in the EU, UK, and US. Without levers to even the playing field, smaller companies and those based in emerging markets, which need transition finance most, will miss out.

Another camp would double down on financing only those assets that are most difficult to decarbonize. The simple math shows no path to net-zero can bypass phasing out coal-fired power plants in emerging markets or transitioning companies in emission-heavy sectors such as cement.

The data shows two growing chasms for transition finance to bridge.

From our experience in helping financial institutions align investments with sustainability, we see financial, regulatory, and reputational roadblocks to financing high-emission assets. Overcoming these hurdles is essential for attracting private finance, which seeks high risk-adjusted returns while satisfying activists and regulatory green finance ratios. We support the many collaborative efforts to remove the roadblocks, including levers for retiring high-emitting assets in the Asia-Pacific region; initiatives to build confidence in the voluntary carbon market; development of definitions, taxonomies and financing instruments targeting transition assets; and quantifying emissions reduced or avoided.

Halting climate change demands speed and scale. That's why we need to experiment, learn quickly and concentrate the confluence of policy and capital on decarbonizing the most impactful assets, which increasingly lie beyond the EU's borders.

IGNACIO GUTIÉRREZ-ORRANTIA
Chief Executive Officer – Citi Europe

Mind the gap: leveraging capital markets to boost the EU's green transition

The EU has made strides towards decarbonising the continent's economy and meeting its ambitious climate targets. Bridging the financing gap, however, remains the EU's biggest challenge to successfully progressing down its transition path.

Despite the progress made, and an average of €764 billion invested annually in the EU over the past decade, more is needed. The European Commission estimates that investment needs to be ramped up by about 60% to reach the EU's legally binding 2030 target. With public finances overstretched across member states, the investment gap can be filled by the capital markets.

Fortunately, the EU has a deep pool of savings that it could draw on to support this effort, but it is currently sitting in unproductive bank deposits. What the EU needs is a structural shift to market-based financing, deepening its capital markets to put these savings to work, earning a return investing in strong European companies with robust transition plans.

European leaders have recently recommitted to the Capital Markets Union (CMU), recognising the need to spur private investment. This initiative, and the efforts to minimise regulatory obstacles, encourage more equity financing, and integrate capital markets, are important to enhance the EU's competitiveness. A clear strategy for a well-functioning CMU, as well as policies to enhance the attractiveness of the EU to international investors and companies, are needed.

The Green Bond is one of the most successful financial instruments for tapping debt markets to fund environmental projects. Even before the EU's new Green Bond Standard comes into force, EU member states have been active in raising €270 billion in green bonds, particularly under the Next Gen EU programme. EU corporates have themselves raised €363 billion in green bonds, led by European giants such as Engie and Iberdrola.

At Citi, we are already playing our part, supporting European companies and governments access the capital markets to fund their transition. In June of this year, we acted as Joint Bookrunner for Heidelberg Materials, a cement and concrete company, when they issued a €700 million green senior bond, the first green bond from a European manufacturer in the heavy building materials industry.

We were equally proud to act as Joint Bookrunner and Joint Structuring Bank for the Government of Romania's inaugural green bond issuance. Some of the €2 billion raised will fund Romania's energy transition, including the conversion of coal power plants to combined heat and power, and retrofitting of gas pipelines to allow for the flow of low-carbon gases such as hydrogen.

Completing the CMU and leveraging the sustainable finance framework are two sides of the same coin, which together can drive the investment needed to fund the EU's green transition. But further efforts are needed to close the funding gap and minimise regulatory obstacles.

As stated by the International Energy Agency in their Net Zero Roadmap (2023 update), international cooperation and coordination is a must-have for companies operating in the EU and to advance the EU's transition. Supporting global frameworks and enhancing the international interoperability of EU regulation will enable international capital to flow more freely to support companies in Europe.

Secondly, market-based incentives are crucial to driving decarbonisation without stifling growth. The EU's European Emission Trading Scheme is the world's pre-eminent carbon market, and the EU should enhance its cooperation with other jurisdictions to promote the development of their compliance carbon markets and possible future integrations.

Thirdly, the usability of the EU Taxonomy should be improved. This core part of the EU's sustainable finance framework could be a key instrument for directing capital towards green projects in the EU. However, it currently acts as a complex reporting burden for many corporates and is insufficient for the needs of investors looking to fund transition projects. Citi welcomes the work of the Platform for Sustainable Finance to increase the usability of the Taxonomy.

Completing the CMU and leveraging the sustainable finance framework are two sides of the same coin.

Finally, while the financial sector is a powerful catalyst, it is the real economy that underpins the transition. Capital markets rely on regulatory stability and the rule of law to function effectively. Reducing risk and maximising the support of Europe's capital markets for decarbonisation, additionally require greater clarity of sector specific transition pathways, including the policies needed to deliver them.

The EU Green Deal has made great progress towards building a more sustainable European economy. Filling the Green funding gap will require equally ambitious strides in completing the CMU.

LARA INÉS DE MESA GARATE

Global Head Responsible Banking – Santander

Transition requires growth, joint action and greening the brown, with the regulatory framework as an enabler

The transition to net zero is a journey, not a point in time, and it encompasses three key elements to succeed:

- First, growth - critical to afford the investment the transition requires and on which Europe has not been excelling recently – less than 30% GDP growth over the last two decades, vs almost 60% in the case of the US.
- Second, joint action across public and private agents. Banks are enablers of the transition, and we are progressing towards aligning our business strategy to net zero pathways. But the challenge requires action from many more, including – governments, regulators, companies and individuals. Governments need to define specific transition pathways for key sectors and technologies, together with the accompanying policy tools and incentives to facilitate the transition.
- Third, the efforts must be directed towards greening what is brown today. The challenge is not for European players to stop financing brown, but greening it in a way that supports economies, communities and the transition, acknowledging that starting points are different.

These three points should all be reflected in the climate related regulation, so it drives an agenda that fosters the transition and creates the necessary conditions for growth, competitiveness and investment to happen. We should always assess whether the all-encompassing regulatory and supervisory framework the EU has, and remains developing, is contributing successfully to promoting sustainable growth.

Banks´ role is to focus on how to best support our clients´ transition journey, by engaging and defining new solutions addressing their needs. We are spending too much time implementing complex requirements stemming from the Taxonomy, CSRD, SFDR and other initiatives. As a result, many see sustainability as a practice that comes with too additional costs and risks, while opportunities are still nascent and uncertain. An enabling environment that fosters innovation to find better solutions is required, providing players with trust and confidence to explore and decide on key action to support the transition, motivated by opportunities more than fearing risks or penalties.

The goal is clear: net zero economies by 2050. The different political momentum can explore different ways to get there. In Europe the new political cycle presents an opportunity to, first, assess how the initiatives adopted to date are contributing to the goal of financing the transition of the economy, and second, simplifying certain approaches that prove too complex to be implemented by companies, while providing little upside. The EU Taxonomy, in addition to rigorous significant contribution criteria, includes Do not significant Harm and Minimum Social Safeguards even for retail operations. Taxonomy criteria should be ingrained in activities and information should be available and flow across market agents. Banks cannot be investing on gathering information from different sources of which not even the debtor is aware. Hence, simplifying the taxonomy approach whilst keeping the same level of ambition (science-based target of 1.5º) should be sought.

In addition, Europe has the chance to seek further coordination with other jurisdictions to progress on the task ahead. Welcomed progress has been attained between the ISSB and EFRAG on reporting standards, but, still, differences remain which make it difficult for companies operating globally. As both standard setters continue with their mandates, it is essential that maximum interoperability is reached across them. Simplification efforts are also needed, including reviewing the number of templates and detailed information that companies need to report on.

The magnitude of the challenge ahead requires pragmatic approaches and alignment of all agents towards the end goal – driving transition, without undue distractions.

The way forward is not to slow down on the transition efforts. We need to do more, following the premise that orderly, just transition depends on concerted action, supporting transition and growth and a regulatory framework that is an enabler, not a trap.

We need more targeted, feasible and efficient approaches, fit for purpose. The temptation in sustainability is often to aim for perfection, but the magnitude and shortage in time to succeed requires pragmatic approaches and alignment of all agents towards the end goal – driving transition, without undue distractions.