Challenges facing the EU sustainability approach

The Chair noted that the Corporate Sustainability Reporting Directive (CSRD) has been approved.

1. ESG goals will remain an important driver for investment. Regulation will help, provided that it is usable, factors in transition and contributes to the competitiveness of corporates and SMEs

The Chair explained that, in Belgium, around 400,000 small and medium-sized enterprises (SMEs) file their accounts, but only around 200 companies are mandated to non-financial sustainability reporting. In future, depending on the approach taken, this number will be 10 times greater. CSRD is a challenge not only for large banks or well-known providers of data, but also for many SMEs that are clients of these entities or in the value chain.

An official commented that achieving goals around sustainability remains vital not just for the planet, but also for the competitiveness of the system at macro and micro levels. Regulation will continue to play a pivotal role in driving investment towards environmental, social and governance (ESG) goals. ESG goals are a key driver of investment, but regulation also helps to shift the focus from short term to long term. An entrepreneur should not need to spend valuable hours navigating administrative requirements. According to the Draghi report, regulatory obstacles are the greatest challenge for 55% of SMEs in Europe. Regulation should be a tool for progress rather than a barrier to growth and innovation.

Focusing on the usability of the framework is an easily achievable goal in the short term. This will include addressing inconsistencies and simplifying processes. For example, overlapping definitions should be consolidated. There is no definition of transition finance in Europe, so there is still some friction in this area. Technical requirements for sectoral legislation should be streamlined so that rules apply to banks, insurance companies or investment funds. In the medium term, a competitiveness test, as proposed by Mario Draghi and others, could be embedded within the policymaking process.

There is a sense that the regulatory journey will be gradual. The level of engagement differs depending on the company or industry. All parties have their own directions, but the debate is going beyond compliance and reporting. There is also a strong focus on what precedes reporting, such as governance arrangements, internal processes and strategy.

An industry representative observed that increasing or broadening disclosure requirements will almost always advantage larger companies. Support for smaller companies is crucial. A more inclusive definition of what private sector finance should target is needed. There are companies that are not yet able to meet the high requirements of the 'green fence', but still show promise for change. It will not be possible to transition the economy without these companies.

An industry representative highlighted that progress has been made on international alignment for sustainability disclosures to reduce fragmentation and duplication and connect them with financial statements. For some time, work has been ongoing on the International Sustainability Standards Board (ISSB), CSRD and European Sustainability Reporting Standards (ESRS), assuming that interoperability will happen and using a common language, which is vital to foster transparency and comparability. The requirements to quantify impact, risks and opportunities are clearly supporting effective integration of sustainability into management. These developments are tremendously positive. Requiring the disclosure of over 1,000 data points might not be helping managers and stakeholders. A simpler approach could be much more effective.

The landscape is currently quite uneven. Recent differences between the US and Europe have been not just in relation to the approach, but also the direction of travel. Europe remains a leader, but a lack of growth and public deficits have hindered progress in transition measures, while supervisory scrutiny of banks has increased. The goal in relation to climate is clearly net zero economies by 2050. The approach to this and goals for transition plans are not yet agreed. Transition should be approached from a global perspective and fragmentation should be avoided. The role of a transition plan as a plan and not an accurate forecast should also be clarified.

Banks' transition plans depend on customers' transition plans. For example, in relation to the mortgage sector in the UK, 28 million houses need to be retrofitted to achieve the goals. Close to 70% of UK adults do not know the energy performance certificate rating of their homes and around 70% of adults stated that they could not afford to install a heat pump. Even if the awareness gap is closed, incentives will be needed.

2. Implementing international sustainability standards is a positive challenge for the companies involved but has not yet triggered a perceptible move in the economy

2.1 EU and international sustainability standards are currently being implemented, which provides corporates with a real benefit in understanding the drivers of value for business and enabling banks to further support the greening of the economy

The Chair noted that the Draghi report warns of the danger of fatigue about climate. To avoid regulatory fatigue, the focus should be on stabilising and converging the regulatory framework.

An official reported that a significant number of companies around the world are preparing for the new type of sustainability reporting. There are currently around 30 jurisdictions that have either made decisions or are in the process of making decisions regarding using the ISSB Standards. This represents more than 55% of global GDP and illustrates the pace of adoption of the Standards around the world. Companies and investors are very supportive of having a global baseline to ensure comparability in reporting around the world.

Companies state that there is a lot to do. It is not easy, and companies need help with education and implementation. Sustainability experts need to be brought together with the financial reporting experts to produce this type of reporting to the high standards necessary and have it accompanying financial statements. That is a big change, but many companies are positive about it because it means that different people are engaged in important conversations internally. Many companies are looking beyond the compliance aspects and observing that there is real benefit in understanding the drivers of value for businesses.

The comprehensive global baseline that the ISSB is developing is designed to be policy agnostic and to enable companies to provide information that investors need to understand on sustainability-related risks and opportunities in order to make investment decisions. There is a continuing focus on ensuring that the information asked for cost effective and proportionate for companies to provide. In addition to encouraging adoption, work will continue to maintain and build on the interoperability that has already been established. Good partnerships with other important stakeholders in the ecosystem, such as Global Reporting Initiative (GRI), Taskforce on Nature-related Financial Disclosures (TNFD), Carbon Disclosure Project (CDP) and the GHG Protocol will improve the efficiency of the system.

The Chair noted that, although the banking sector must implement many standards and regulations, it is clear that it is supportive of the green journey. The banking sector is possibly not as heavily affected as industrial concerns are in respect of implementation, but it is still a challenge.

An industry representative commented that current key discussions are around sustainable growth and measuring, managing and reporting impact, risks and opportunities for affected communities. Companies need to be able to evidence to the market how they are creating value by integrating sustainability. The challenge is integrating sustainability in a way that creates tangible value and where competitiveness is reinforced instead of undermined. As the Draghi report states, climate policy should not be applied without an industrial plan, and this is correct. Transition should secure a competitive advantage for Europe and help it to grow faster, providing responses to stress situations and the lack of dynamism and growth.

A banker states that his bank is supporting corporate and investment banking customers in high-emitting sectors that are already deploying cutting edge technologies. Socially responsible investment offerings have been deployed. However, too much time and effort are being spent on implementing developments such as the taxonomy and CSRD. These should be enablers to facilitate action and change and should not be traps. Sustainability still too often involves additional costs and risks, while opportunities are not mainstream. Simplification is needed, as President Macron and Draghi have made clear, and that requires courage.

An example of this is in relation to the taxonomy. Europe made an important contribution when defining what 'significant contribution' means but adding European taxonomy aiming for perfection and 'do no significant harm' and minimum safeguards has increased the complexity. Banks finance the whole economy and should not be asked to check and provide evidence for the rolling noise and resistance coefficient when financing mobility solutions, for example. Instead, this should be part of the licence to operate in the transport sectors. Banks should be able to use counterparty 'do no significant harm' and minimum safeguard assessment. This is not for the benefit of the banks but instead is to embed sustainability sufficiently for it to be a source of competitiveness.

An industry representative commented that banks are facilitators and enablers of change. There are different industries and different countries, and everyone has different needs. The practicalities of helping clients, industries and governments to transition must be navigated. This requires a very granular engagement with clients on an individual basis.

The EU sustainability agenda is one of the most far-reaching in the world, but it comes with implementation challenges. An American bank in Europe has been mobilising resources and capabilities to support the objectives of the European Central Bank (ECB) and the European policy makers, in line with its own principles: $1 trillion of sustainable finance by 2030 and achieving net zero by 2050. Current focus is more on environmental risk, including biodiversity. In response to an increased focus from the regulators, solid greenwashing principles have been established to ensure that the sustainability of products and services is clear, fair and not misleading.

CSRD will require that 50,000 companies in Europe and 10,000 non-European companies will be required to report against 12 European sustainability reporting

standards. This will be a significant change in corporate transparency. Investors are excited because ESRS will provide millions of comparable and widely available data points. This will enable the creation of richer and deeper ESG indexes and investment strategies. However, corporates are struggling with resources to carry out the reporting. Institutions are sometimes trapped in an overlap between the EU framework and other existing frameworks. In that respect, the work of the ISSB in trying to align the global and the European framework is very welcome.

2.2 Companies leading the effort to disclose sustainability data tend to be large and EU based

The Chair noted that the costs and complexity of the journey should not be underestimated.

An industry representative explained that she considers the situation from two different perspectives. An international ESG data and ratings provider is a major consumer of sustainability data disclosed by companies around the world, and it also serves global financial institutions that are incorporating that data into their investment processes. Both sides have recently asked whether there has been a reduction in the growth of sustainable investing and, if so, whether the benefits to them as seekers and providers of capital still outweigh the increasing costs.

The sector has subscribed to a theory of change that suggests that capital will flow towards the companies that are most transparent, most ambitious and progressing the fastest, and away from those who are lagging. Considering the approximately 8,500 companies that make up around 99% of the value of publicly listed markets globally, leading companies tend to be large, and EU based. Larger companies disclose emissions data at nearly twice the rate of the medium and smaller-size publicly listed companies. The percentage of EU-listed companies that are aligned or aligning with net zero is almost triple the percentage of non-EU-listed companies doing so.

2.3 Corporate disclosures on sustainability targets have not led to a significant impact on the sustainability of the economy

An industry representative stated that the global sustainable bonds issuance volumes continue to be very strong, with an increase of 4% in the current year and an issuance of $717 billion to date. The majority comes from the European region. There are $4.4 trillion of outstanding sustainable bonds. Around 60% of these are green bonds. 17% are social and 18% are sustainable. Only 10% to 15% of the whole euro or dollar bond issuance globally is labelled as sustainable. However, that number increases to 26% to 30% when it comes to European corporate bond issuance.

The European Commission is clear that investments need to increase by 60% to meet the 2030 target. Ensuring that the money flows from the private sector or the capital markets into these investments is a collective responsibility and pragmatism will be needed. Capital markets union and leveraging the sustainable finance framework are closely linked. Despite ongoing regulatory activity and discussions, the target will not be achieved without capital.

An industry representative noted that, despite large companies in developed markets attracting the bulk of the sustainability focused private sector investments, there has not been a significant impact on the full market or the economy. The world's listed companies account for just under one-fifth of the world's scope one greenhouse gas (GHG) emissions. According to the MSCI net zero tracker, this figure has not changed much in recent years. Allocating capital towards the most transparent and green companies that can meet a long list of eligibility criteria is leading to a smaller investment universe that will not be very consequential in the wider context of global capital markets and does not motivate change in the parts of the economy that need it the most.

2.4 Capital is currently flowing into transition of heavy emitting sectors. Data on investment in climate focused funds by private equity, private credit and venture capital funds is scarce

An industry representative advised that the focus for the future should be on capital flows that show growth and opportunity. Currently, capital is flowing to transition and private markets investments. Most transition labelled funds were launched in the last couple of years. These are mostly in actively managed equity funds. 70% are based in the EU but it is estimated that around 70% of the companies held in these funds are based in the US. In the private equity, private credit and venture capital funds context, climate focused funds are a nascent area that is growing very quickly. Very little data about these companies is available but they are disproportionately in the heavier emitting industries. Any approach that constricts the green investment universe reduces the opportunities to make a change and to make returns.

3. Coordination and coherence are needed at national, EU and global levels

3.1 Cooperation between the private and public sectors is needed to solve real-life ESG problems and engage SMEs of all sizes

An official observed that, if a regulation becomes a box-ticking exercise, the benefit will be limited. A cooperative approach between policymakers and market players are crucial. The Italian Ministry of Economy and Finance has recently produced a plain language 50-page document providing definitions, formulas and converting factors to assist companies in assessing and managing ESG impacts. The guidance document is targeted at non-listed SMEs and micro enterprises with fewer than 10 employees. These companies are not affected by mandatory rules but are crucial for the overall process. Improving accessibility to ESG information is critical. Sometimes information is already within the company, but the entrepreneur is not aware of it. More often, the company needs to rely on external data sets.

Technology must be leveraged to streamline not just the

collection but also the use of this information. Leveraging technology could include creating a single point of entry so companies and the financial sector can access information in a streamlined way or by using an artificial intelligence solution to calculate metrics required by banks in a more efficient way.

3.2 Political cooperation on whether to define net zero targets, tax incentives and disclosure standards for sustainable development, considering a global economic and political perspective, is also necessary

A regulator commented that the Draghi report is very informative and interesting from a Japanese perspective. There are differing positions on many issues, for example when to achieve net zero. Advanced economies are aiming for 2050, while some of the major emerging economies are aiming for 2060 or 2070. There is a difference in the interpretation of common but differentiated responsibilities. When discussing disclosures or transition to net zero at a corporate level, the metrics used are actually a global standard. Corporates will try to adjust in line with the global standards, but nationally determined contributions could vary. The fundamental challenge going forward is the inconsistency between what the countries do and what the corporates do.

Japan is a strong supporter of the ISSB, particularly of the inaugural ISSB Standards, IFRS S1 and IFRS S2, that have been issued in June 2023. The Japanese standard setters have published an exposure draft that we believe provides a functionally aligned outcome with the ISSB Standards. The engagement with the ISSB has been very constructive. A public consultation has been carried out and is being finalised. It is crucial that the standard itself is not undermined. This is particularly important from a market capitalisation basis. At the same time, we need to carefully consider the need of scalability and phase-in approach, for example, allowing preparation time for reporting. These points will be important in the actual application of the standards, in particular in the context of emerging market economies and SMEs.

When considering the disclosure standards and transitioning, a whole of the economy, as well as whole of the government approach must be taken. Finance plays a pivotal role and can provide encouragement in our efforts. However, governments need to consider not only finance but also incentives such as tax breaks, subsidies and carbon pricing as tools to enable the transition to net zero. In addition, while climate change, or decarbonisation, remains to be one of the highest priority issues, we must carefully consider its implications from a macroeconomic perspective, including competitiveness and geopolitical risks.

An industry representative commented that people often refer to different things when discussing fragmentation. In sustainable investing there is sometimes some confusion between jurisdictional fragmentation and definitions and traditional market segmentation. Regardless of region, there have always been investors who have a very financials-first approach, considering ESG factors, and investors who are very impact focused. The difference now is that investors with fiduciary constraints in many markets need to become clearer and more consistent about which objective they are targeting. The data and analytics have always existed in a modular way that enable investment institutions to construct strategies and products that meet different investment objectives or their own objectives. This clear segmentation is a healthy development for the market and should not be regarded as fragmentation.

In relation to jurisdictional differences around what words can be used to describe a sustainable strategy and what activities are allowed, the field is going through a somewhat painful adjustment period. There is a deglobalisation in how sustainable investing is being practised and labelled. Institutions and investors across all regions have indicated that there is very little appetite to accept someone else's definition for a certain word or activity. There has been a move from a world where an institution could have the same laundry detergent with the same brand in different jurisdictions to one in which there is the same detergent but different brands or formulations for different regions. The rules must be sufficiently clear and, most importantly, stable, so that it is possible to manage which formulations of which brands go in which markets.

An official noted that many people have requested that standard setters do everything they can to reduce complexity. It is difficult for companies to adhere to the different and fragmented regulations and reporting requirements around the world. This illustrates the need for the ISSB's work. The ESRS-ISSB Standards interoperability Guidance, produced in collaboration, has been very well received in the market. The guidance has signalled that it is possible to present disclosures in a way that reduces the risk of duplication in reporting and meets both the European and the ISSB requirements.

Companies often highlight the importance of retaining a high degree of good interoperability with Europe. Jurisdictions should be encouraged to use the ISSB Standards without modification to prevent the introduction of friction into the system and reduce fragmentation. The IFRS Foundation has taken responsibility for the Transition Plan Taskforce's disclosure requirements and will encourage alignment with the ISSB's work in this area to eliminate another potential source of fragmentation. The aim is to make the process as efficient as possible, so that the focus is on managing sustainability risks and opportunities rather than on reporting.

A regulator reported that the Brazilian G20 presidency is particularly focused on promoting sustainable finance, including disclosure standards, in emerging economies and SMEs. The Sustainable Finance Working Group has highlighted four considerations. First is to consider reasonable adjustments. Second is to consider using digital technologies. Third is to promote activities and initiatives that build skills and technical capacity. Fourth is to seek interoperability and harmonisation. These points will continue to be relevant in the international context.