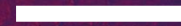




Policy Brief

ESG INVESTING: BEYOND THE STANDARDS



Task Force 7
International Finance and
Economic Recovery

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Abstract

In the face of increased pressure from investors for information and the complexity of disclosing the relevant data, the public and private sectors agree on the need to simplify environmental, social and governance (ESG) reporting. The consolidation of the existing efforts in a coherent framework is essential in ensuring fairness and transparency of the assessments. So far, the efforts remain segmented across the globe.

This policy brief focuses on the ingredients necessary to help design a framework to ensure that ESG investing is held accountable to its promises, from clarifying what ESG investing means to defining standards and benchmarks.

Challenge

The different frameworks and formats, combined with the growing demand for information from investors, make it challenging for firms to identify which information to report and how it may impact them. Even if they use materiality to guide their internal strategy development process, firms are increasingly reluctant to share their materiality matrices publicly.

There are numerous alternatives for sustainability reporting. Among them, the most recognisable are the Carbon Disclosure Project (CDP), Climate Disclosure Standards Board (CDSB), the Global Reporting Initiative (GRI), the International Integrated Reporting Council (IIRC), the Sustainability Accounting Standards Board (SASB) and the Task Force on Climate-related Financial Disclosures (TCFD) to name a few.

The International Sustainability Standards Board (ISSB), established at COP26 within the International Financial Reporting Standards (IFRS) Foundation, seem the best equipped to define a global baseline in environmental, social, and governance (ESG) reporting. Indeed, the IFRS is already home to the International Accounting Standards Board (IASB), which focuses on financial reporting.

In March 2022, the ISSB launched a consultation on two exposure drafts that "consolidate content from the TCFD, CDSB, SASB, Integrated Reporting, and the WEF IBC's stakeholder capitalism metrics into a coherent whole." These proposals create a comprehensive global baseline of sustainability disclosure: One on the general sustainability-related disclosure requirements and the other on the climate-related disclosure requirements.

One of the main clarifications of these documents is the scope of the issues relevant to ESG investing. In line with the United States Securities and Exchange Commission (SEC), the ISSB focus on single materiality, information that drives valuation and matters to investors. In contrast, the European Union's corporate sustainability reporting (CSRD) emphasises double materiality, which includes information of interest to stakeholders even if it is not of interest to investors. Dynamic materiality, a concept used later in this policy brief, links both definitions, allowing ESG factors to change over time.

The ISSB proposals are a significant step in the right direction, but more is needed. In a recent announcement, the ISSB chair and vice-chair emphasised the need for an industry-specific approach to the standards that will be included in the exposure proposals.

Beyond the industries, the standards or the paths to achieve them need to account for countries' specificities, priorities and levels of development. Finding the right balance

between what is achievable individually and what is necessary globally is a significant challenge. Still, the effectiveness and credibility of any ESG framework depend on its global application.

So far, climate change is monopolising most of the attention. Yet, the framework needs to be broader, including other “E” issues, such as biodiversity. It should also include the “S” and “G” dimensions which will bring other challenges as both dimensions are directly related to within-firm culture and hence sensitive.

Finally, these standards will give credibility to ESG reporting and help assess the company's progress towards its goals. However, so far, potential ESG investment's positive impacts on society and the environment do not target the United Nations Sustainable Development Goals (SDGs).

Proposal

If properly designed, the global ESG framework and standards should guide firms to disclose ESG information that will help:

1. the companies to adjust their strategy depending on their goals and understand the corresponding impact on their ESG assessment;
2. the investors to have a better understanding of a firm's non-financial risks and be able to compare that information across firms; and
3. the domestic and international regulators and authorities to better monitor how firm-level efforts help advance longer-term goals at the societal or country levels. It should also help identify longer-term factors that matter in the context of double and dynamic materiality.

In line with Lopez et al. (2021, 2020), this policy brief reiterates the importance of an overall and global ESG strategy, from clarifying the meaning of ESG investing to setting standards and benchmarks to assess progress at the firm, industry and country levels.

The following five questions point out essential ingredients in designing a global ESG framework that would be applicable globally.

1. WHAT IS THE PURPOSE OF ESG INVESTING?

The prime focus of ESG investing is to mitigate non-financial risk at the firm level. However, as captured by the dynamic materiality, the relevant factors may vary over time: what can be perceived as financially immaterial today may become essential to the business tomorrow. Illustrations, from climate change and its impact on businesses to the impact of the recent pandemic on economies and industries, are not lacking.

Clarifying the purpose of ESG investing will help address issues such as greenwashing. It will also realign investors and other relevant parties' expectations with the notion of sustainability in the context of a corporation: sustainability or resilience at a firm's level is different from sustainability at a country or society level.

2. WHAT DOES ESG INVESTING IMPLY?

This question focuses on the implementation of ESG investing. In line with the ISSO standard-setting approach that differentiates across industries, the global ESG investing framework needs to account for countries' specificities, from their geography to their level of development and other societal differences.

A global framework will only work if most countries have a feasible path to reach the commonly agreed goals. The evolution of some non-financial risk factors and their impact on materiality, or dynamic materiality, require a regular assessment of the goals, paths and factors. The frequency of this assessment should vary from every five to every 10 years, depending on the factor and the trade-off between the cost of implementing changes and the pertinence of a factor.

3. WHAT ARE THE RELEVANT METRICS AND BENCHMARKS?

The definitions and goals defined in the global framework need to be translated into metrics, standards, and benchmarks. The emergence of a common global set of standards will enable (i) businesses to identify, manage and communicate on sustainability-related information that is financially material, and (ii) countries, jurisdictions and industries to set benchmarks at their level. These could then guide firms regarding potential targets and the timelines to achieve them within their ecosystem.

Most current ESG metrics focus on whether organisations engage in specific ESG-related activities. They do little to understand the impact of these policies and activities or measure their progress.

4. WHAT ARE THE RELEVANT POLICIES?

The credibility of the ESG global framework and, ultimately, the success of ESG investing depends on the applicability of the standards across countries with very different politico-socio-economic conditions. That is, they rely on local authorities to ensure the integrity of the data and information shared.

Countries' politico-socio-economic conditions strongly influence their ability and willingness to prioritise ESG goals in their policies. While consultations with representatives of developed and less-developed countries' public and private sectors are the first necessary step to designing a genuinely global ESG framework, more needs to be done. Some countries will need extra support such as access to expertise or financial and technical help to prioritise ESG-minded policies. A companion programme is necessary to guarantee its global implementation and alleviate some short-term financial costs that could be prohibitive to some countries.

An inclusive process in defining the framework and policies will minimise potential unexpected consequences that usually arise when solely developed markets drive global regulation. A companion programme will provide the proper incentives and support to facilitate the buy-in of the countries where ESG goals are low in their priorities.

5. HOW TO ENSURE THAT THE DATA COLLECTION AND THE ASSESSMENT PROCESS ARE TRANSPARENT?

If the steps described previously are respected, then the global ESG framework and related standards will lead to a more transparent and streamlined information-collection process. The resulting data will be consistent across firms, of improved quality, and at a lower cost.

Next, the third parties' aggregation process leading to the ESG assessment of firms needs to be more transparent. The ratings and scores are helpful to companies and investors only if they understand what these assessments entail. Different emphases on "E", "S" or "G" are informative as long as the rating users know it. Enhanced transparency regarding the methods would help investors, firms and other users, choose the rating that most aligned with their priorities. Due to the complexity and the novelty of ESG assessment, benchmarks, scores and ratings would benefit from regular assessment of their effectiveness at protecting investors from significant underlying risks.

THE ROLE OF THE G20

ESG investing's credibility lies in its ability to be held accountable for its promises, from non-financial risk assessment and long-term valuation to the positive impact on societies and the environment. Global standards and a common framework are the necessary next step to ensure the proper changes at the corporation's level. G20 with other international groups such as the UN and the International Organization of Securities Commissions (IOSCO) have been essential in the recent progress towards harmonised standards.

There is little doubt that global sustainability-reporting standards focused on enterprise value will emerge in the next year or so. What is less clear is how inclusive the process to define them will be when it comes from stakeholders from different regions/countries. As discussed previously, representatives from the different industries from developed and emerging markets need to be involved in setting the goals, standards, benchmarks and timelines. The standards, goals and paths to reach them may differ by industry and a country's level of development, finding the right balance between implementability and practical impact. It would be counter-productive to global sustainability to have developed markets imposing the rules.

The G20 is a natural platform to facilitate this work across geographic jurisdictions and stakeholders. It would not be the first time for the G20 to develop a global framework in response to a standard global shock. The previous one was the macroprudential policy framework after the financial crisis. This experience could provide helpful insights into the challenges of defining a framework and standards that will have the buy-in of most countries.

Furthermore, developing the common standards and framework will be iterative. Similar to the scores and ratings, the metrics and benchmarks must be evaluated regularly in their effectiveness to protect investors from significant underlying risks and help achieve the agreed-upon goals. They should be adjusted when necessary.

WHAT ' S NEXT?

The current framework is mandatory for a large public firm, but it is enough when considering societal and environmental changes.

There are clear arguments in favor of mandatory ESG disclosure. Krueger et al. (2021) show that it improves the availability and quality of ESG reporting, increases the analysts' earnings forecasts accuracy and reduces harmful ESG incidents and the danger of a stock market crash. Hence, mandatory ESG disclosure, according to the research, has both informative and real-world benefits. However, it places undue pressure on businesses while some are just beginning their sustainability journey. Many claim that voluntary reporting is market-driven and gives reporting enterprises a competitive advantage, making it inevitable. However, in April 2021, the SEC issued a risk alert to raise investors' awareness of "misleading statements regarding ESG investing processes and representations regarding the adherence to global ESG frameworks."

Furthermore, there is a question of firms' size. So far, most mandated reporting instruments focus on large or publicly traded enterprises. Small and medium enterprises (SMEs) represent around 90 percent of businesses but only 10 percent of GRI Sustainability Disclosure Database reports. SMEs have great importance in achieving the ESG goals at the country and industry levels. The finalised common framework and global standards will minimise the burden of compliance, especially when compared to the cost of filing for several reportings. It will make it feasible for SMEs to join and compete on the global ESG playing field.

To conclude, it is worth emphasising that the recommendations in this policy brief rely on a private-public effort among companies, auditors, standard-setters, rating providers, governmental and international institutions. The credibility of ESG investing depends on the disclosure of information helpful in making decisions and assessing a company's risk and long-term value. It requires the different stakeholders (firms, investors, governments, international institutions and regulators, among others) to educate each other on how the firms' initiatives will impact their business and resilience, society and the environment, in each geographic jurisdiction and industry.

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