European Securities and Markets Authority

8 December 2020
ESMA 32-67-765

The three (apparent) paradoxes of sustainability reporting and how to address them

Webinar organised by the Secretary of State for the Social, Inclusive and Responsible Economy of the French Ministry of the Economy
A new standard for a new capitalism: accelerating corporate responsibility through non-financial information

8 December 2020

Steven Maijoor

Chair

European Securities and Markets Authority

Ladies and gentlemen,

I would like to thank the French Ministry of the Economy, Finance and Recovery and, in particular, the Secretary of State for the Social, Inclusive and Responsible Economy for inviting me to speak at today's important webinar on non-financial information.

I will use my time today to share some brief reflections on what I consider are the three main apparent paradoxes in the area of sustainability reporting.

International but also jurisdiction-specific standards

The first paradox relates to the the need to ensure that reporting standards

are, at the same time, international and jurisdiction-specific.

A little less than a year ago, I gave my first speech on sustainable finance[1] in which I emphasised the key role that rigorous and standardised ESG disclosures can play in preventing the risk of greenwashing. Interestingly, it was my first intervention on this topic, but it was also one of the last ones I made in the pre-COVID era.

Since then, remote working arrangements have become the norm in several sectors and this has accelerated the digital transition. The economic downturn has required unprecedented public support measures, highlighting the relevance of the social dimension in the functioning of our economies.

It is too early to say to what extent these aspects will have any transformational effects on the financial and economic system over the long term, but one thing that the pandemic has clearly shown is that international interconnectedness remains a key feature of the functioning of our financial and economic systems, and will be even more so in the post-COVID recovery.

Almost all developed countries face the risk of having to slow down the progress towards the environmental objectives of the Paris agreement, due to the economic consequences of the pandemic.

In order to mitigate this risk, as recently highlighted by the IMF[2], improved transparency and standardisation in sustainability taxonomies and

[1] https://www.esma.europa.eu/sites/default/files/library/esma32-67-642_european_financial_forum_2020_-_12_february_2020_-_speech_steven.pdf
[2] https://www.imf.org/-/media/Files/Publications/GFSR/2020/October/English/text.ashx

reporting could further help mobilise green investments and support major recovery programs, such as the Next Generation EU.

But there is also another more general reason why international cooperation in the development of ESG disclosure standards is key, even when jurisdictions have already developed a robust framework for sustainable finance, such as in the European Union.

The international flow of investments that will be needed to support the green transition will require the assessment of investee companies by investors based in third-countries. Similarly, EU investors may well target investee companies based in third countries. In both cases, the relevant assessments can be made much more effective and efficient by the availability of a set of generally accepted international reporting standards.

Therefore, from the perspective of financial markets, I do not believe that global and EU-specific standardardisation are in contradiction but that they will be complementary to one another. For that to be the case however, obviously, not *any* international solution would be beneficial for EU financial markets.

To be effective, a set of international standards will need to be modular to cater for the needs of jurisdictions that are at different stages of progress in the area of sustainable finance, rather than merely set a *minimum common denominator*; they will need to build on the most advanced standards already developed in international and regional fora, including the TCFD. They will also will have to take an approach to materiality that adequately reflects both the impact that ESG factors may have on reporting companies, as well as the impact that these entities might have

on society at large and which investors are increasingly equally interested in.

Obviously, the availability or even the reliance on a common set of international standards does not impair the sovereignty of the EU in the sustainability disclosure area. In my view, it will rather reinforce the leadership role of the European Union in international cooperation that is already at the heart of the Commission's initiative to promote the International Platform on Sustainable Finance.

Nor will an international standard prevent Europe from adding to such a standard, when this will be needed to reflect EU-specific policy objectives in the area of sustainable finance.

ESMA is ready to assist EU institutions in assessing the compatibility of a possible set of international reporting standards with the EU public interest, most notably, for what concerns investor protection and financial stability. Let me finally say that the current consultation by the IFRS foundation is an initial but important step in the development of international sustainability reporting standards.

Robust but flexible reporting requirements

The second paradox relates to the importance of ensuring that the disclosure standards are sufficiently robust to help prevent the risk of greenwashing, while at the same time allowing for sufficient flexibility for entities to tell *their own story*.

I would like to emphasise that we should not be naïve regarding the risk of greenwashing. Whenever information is used in investment decisions

and relevant to the allocation of captial, and it affects the fortunes of companies and individuals, there are risks that the information is biased, or even misleading. There is no difference here between financial and non-financial information, and we should do our utmost to reduce as much as possible the risks of non-financial reporting scandals occuring, which would undermine trust in sustainabilty finance.

What is often emphasised about greenwashing is the element of misconduct that leads representatives of issuers or financial market participants to provide false or misleading information to the market, regarding the sustainability profile of a certain company or investment portfolio. This is indeed an important aspect, but it is only the tip of the iceberg.

Greenwashing is also an issue that has a lot to do with the degree of robustness of the framework underlying the reported data. To take one well-known example, as it was later ascertained, the data manipulations leading to the "dieselgate" scandal[3] could happen also because of weaknesses in the EU system for measuring vehicle emissions.

When trying to transpose this unfortunate case onto the corporate reporting area, we clearly see that the risk of greenwashing there is rather high and pervasive. In fact, not only is the absence of common reporting standards making it possible for entities to *cherry-pick* the aspects they wish to shed light on, but this lack of consistent data has consequences along the entire investment value chain.

---

[3] See the report from the European Court of Auditors on the EU response to this scandal here: https://www.eca.europa.eu/lists/ecadocuments/brp_vehicle_emissions/brp_vehicle_emissions_en.pdf

One example of that is how divergent reported data ultimately feed into the databases of ESG rating or scoring providers, the work of which is one of the ingredients for investors' decision-making. Ultimately when greenwashing practices surface and the misstatements become public, it is often too late: such practices may have long-lasting, harmful effects on the credibility of the whole sustainable transition which, as a result, may be delayed, thus posing risks not only to investor protection, but also to financial stability.

In other words, greenwashing gives rise to a contagion chain and there is no single-shot *vaccine* to address it, but it is rather a combination of measures that can prevent it from spreading, and high-quality non-financial disclosures is one of those measures. I would therefore recommend considering three key principles of robust standard-setting for non-financial reporting.

Firstly, it is important that the standards are developed in the public interest and on the basis of an independent due process. The role of private sector initiatives remains important, but in setting the future standards it is key to ensure that ultimately public authorities can exercise the appropriate level of oversight. Of course, this can go hand in hand with extensive and thorough consultation of all relevant stakeholders.

Secondly, for the reasons I explained earlier on the impact that ESG data and disclosure can have on the investment chain, the protection of users of such information should be at the heart of the future standards. This implies making sure that the standards reflect all relevant areas of the ESG spectrum and that they are built considering the views of multiple stakeholders, including retail investors and civil society.

Thirdly, it is important that the standards are principles-based, but also sufficiently specific to help their consistent application, auditability and enforceability. This is a fine balance to strike and the IFRS standards are a good example of a continuous improvement process in this area.

Principles-based standards are typically well-suited to support the efforts of those issuers that aim at innovating in their reporting practices, but they are also helpful in preventing the risk that non-financial reporting is merely based on a check-list approach. Hence, robust standards are only in apparent contradiction with the objective of telling an issuer's *own story*, a practice which I would very much encourage.

Proportionate but complete reporting

My third and last paradox refers to establishing a robust and extensive disclosure regime covering as many companies as possible so to ensure that information by (actual or potential) investee companies is available, while maintaining a proportionate set of requirements especially for smaller companies.

This is perhaps the most difficult of all issues to be addressed so far and one for which no off-the-shelf solution exists. Clearly, some smaller companies may be part of heavily polluting supply chains while others may be less relevant from the sustainability perspective. How do we measure their impact and how do we establish requirements that are proportionate to their reporting capacities whilst still providing the relevant needed information?

One potential way forward is to acknowledge that the size of a company alone is an imperfect proxy of its ESG impact, but that at the same time it

is a relatively good indicator of the resource constraint that a company might face if a heavy reporting burdens is imposed on it.

On that basis, the most appropriate solution would seem to me the establishment of a differentiated and simpler reporting regime for SMEs, so as to ensure that basic data points are made available at reasonable cost, just like today virtually all companies report on some key financial metrics.

Conclusion

Ladies and gentlemen, let me conclude.

The future of sustainability reporting depends, in my view, upon good international cooperation, robust, proportionate and principles-based reporting requirements and, most importantly, on a standard-setting process that is centred around the public interest. Like for any standard setting process, extensive and thorough consultation of all relevant stakeholders will also be essential.

ESMA will continue to be vigilant on developments in this area, and contribute to them with the objective of preserving investor protection and the stability of financial markets.

Thank you.