REPORTING AND GOVERNANCE

Interoperability of ESG standards key if ISSB is to succeed

Victor Smart | April 4, 2022

Interoperability between standards is key if the much-vaunted International Sustainability Standards Board is to prove effective in setting a new regulatory global baseline on disclosures. The new OECD-backed Impact Management Platform may help bridge the gap across jurisdictions. By Victor Smart

The creation at the UN's COP26 climate change talks last November of the International Sustainability Standards Board (ISSB) to deliver a comprehensive global baseline of sustainability-related disclosure standards was welcomed as a landmark step. But one early decision has created immediate interoperability problems.

The ISSB chose from the start to opt for a so-called enterprise value approach looking at the risks (and opportunities) environmental changes pose to a company's profitability. Rooted in traditional risk management practice, that looked a sensible place to start. And it seems likely that this will be the philosophy adopted by the US, where the Securities and Exchange Commission recently announced proposals for mandating climate-related disclosures.

But critics were quick to complain that this methodology fails to show what really matters, namely, the often damaging impacts on the environment of businesses' activities. As such, on the face of it the enterprise value approach looks to be sharply at odds with the desire of many individual ESG investors who think their assets should at the least be doing no harm to the planet, and maybe some good. It also runs counter to the regulatory approach being adopted by the EU and the UK.

Double materiality approach

The Europeans, regulatory leaders in the field of green investment, have veered towards so-called double materiality. In corporate reporting on sustainability issues, a firm's impact on the environment counts if it can be said to be 'material'.

Double materiality looks at impacts in both directions: on the effect on a firm on the environment and vice versa, both in terms of its profitability but also how its performance might affect societal, environmental and social policy objectives. This approach will be embedded in the EU's forthcoming Corporate Sustainability Reporting Directive and in the UK's Sustainability Disclosure Requirements, although the UK is inclined to split the two regulatory objectives.

Significantly, three weeks after the ISSB's creation, the OECD, the UNEP Finance Initiative and various other organisations set up the Impact Management Platform (IMP). Designed to streamline the work on measuring ESG impacts, the new IMP can be seen as a part in a new global ESG regulatory architecture, conceived with the ISSB at the centre.

Eric Usher, head of the UNEP Finance Initiative, told *Global Risk Regulator*: “The platform partners are committed to improving interoperability between existing sustainability standards and frameworks. The work of the IMP could be a sandbox for the future work of the ISSB by virtue of the depth and breadth of its collective experience and networks.”

The new global platform is an umbrella organisation of 17 partners, all seen as leading providers of sustainability standards and guidance. No fewer than five UN organisations are represented. Also partners are the Global Reporting Initiative (GRI), World Benchmarking Alliance and the Value Reporting Foundation (formed from a recent merger of the Sustainability Accounting Standards Board and the International Integrated Reporting Council).

Through the platform, the partners have vowed to work together to identify opportunities to consolidate existing sustainability resources, collectively address gaps, and co-ordinate with policy-makers and regulators to support the mainstreaming of impact management.

“The IMP aims to help provide coherence for practitioners to clarify the actions and landscape of standards for managing sustainability impacts … As part of our work programme, we will be publishing our research and development agenda shortly, which aims to address gaps in the ecosystem of sustainability impact standards,” comments Romina Boarini, director of the OECD’s WISE centre, which is focused on wellbeing.

Adds Felicity Hall, senior associate, climate and sustainability, at strategic advisory firm Global Counsel: “It is great to see an initiative which is bringing existing knowledge, expertise and best practice together while not necessarily trying to add something new to the mix.”

For the IMP, impact is framed overall in terms of meeting the UN’s interlinked Sustainable Development Goals: these range from ending poverty with strategies that improve health and education, to reducing inequality – all while tackling climate change and working to preserve oceans and forests. At a more immediate technical level, the new impact management organisation will be encouraging the use of the Financial Stability Board’s Taskforce on Climate-Related Financial Disclosures (TCFD); over the past few years this framework has become an essential part of the global ESG architecture, increasingly mandated by supervisors across jurisdictions to support both transparency and the ability to compare cross-border.

The platform’s first actual product is a regularly updated webtool that explains the core actions of impact management. The IMP website bills itself as an essential ‘go-to” for practitioners. That seems aspirational for the moment at least; it is still early days for the IMP and at this stage the work is not just high level but also highly conceptual. Significantly, the IMP’s secretariat itself will not be developing policy or acting in a directive way. Even the term ‘best practice’ is eschewed as being too prescriptive. Rather, the IMP is seen as a safe space for the partner organisations under its umbrella to agree new measures.

Thinning down initiatives

If the advent of the IMP led some of its partners to merge that would clearly be welcome; the ISSB was itself the result of several mergers (including of the Sustainability Accounting Standards Board and the International Integrated Reporting Council), thereby making a start at thinning out the thick tangle of initiatives, regulations, frameworks, networks and institutions that make ESG rules so hard to navigate.

And, in an encouraging sign in March, it was announced that the GRI's Global Sustainability Standards Board and the ISSB will seek to converge their standard-setting activities.

Meanwhile, bridging the gap between the distinct enterprise value and double materiality approaches may be among the IMP's most pressing challenges. One problem is that, as Harvard Business School's Impact-Weighted Accounts Initiative says: "Measurement, no matter how sophisticated, is much better at capturing easily quantifiable inputs than complex and messy outcomes and impacts. Companies need to do everything they can to understand those outcomes and impacts – and that requires doing more than just measurement. In particular, companies need to do three things: zoom in to develop insights on processes, zoom out to see broader systems, and value curiosity and learning."

In addition, it may be harder to weigh the risks posed by a firm to the environment than the risks environmental change poses to a firm. While some impacts, say, sustainable water use, can be fairly readily quantified, other ESG impacts are more difficult to give a value to. That's particularly true of social issues, such as the use of forced labour in the supply chain or desecration of sites holy to indigenous people: it can be a stretch to ascribe a quantitative value to a predominantly qualitative issue.

The sheer number of the impacts to be measured is also often cited as a key barrier to good ESG impact measurement. That's a special problem for smaller businesses which will need to prioritise and focus on the most material impacts for their business in order not to be overwhelmed by the need to collect information.

The EU may have been explicit that it will require large publicly quoted firms to be transparent both on the risks posed to their operations by sustainability issues, but also on the impact that the companies have on sustainability. But it has yet to add significant detail on how granular impact disclosures will need to be.

Global Counsel's Ms Hall comments: "Regardless of that, this policy shift creates a strong need for clarity on best practice when it comes to measuring ESG impact. This is where there is a role for the IMP in guiding companies and investors towards the standards which will help them address their ESG impacts." Additionally, the work of the IMP to support co-ordination among the host of voluntary reporting initiatives will be valuable in getting closer to harmonised reporting.

It is significant that, while the two reporting approaches – enterprise value and double materiality – are usually seen as binary, there has recently been some blurring of the edges.

Mark Manning, technical specialist for sustainable finance and stewardship at the UK's Financial Conduct Authority (FCA), recently told a UK Sustainable Investment Finance conference that the FCA thought it absolutely right that the ISSB was using an enterprise value approach. "But it's really important that there is interoperability between the global baseline of enterprise value-oriented standards and any additional jurisdiction-specific standards that might capture the external impact of issuers on the environment and society that are not otherwise captured in that enterprise value-oriented set of standards," he explained.

"I think we've got a really good opportunity here globally to set a baseline of enterprise value-oriented standards but with flexibility to layer on top of that, including here in the UK."

Mr Manning’s comments reflect the views of the ISSB which is also now talking about “different layers”, implying that an EU layer, for example, could sit comfortably above the ISSB’s base layer.

New Zealand’s approach

Interestingly, when New Zealand’s External Reporting Board (XRB) recently adopted enterprise value over double materiality it argued that, contrary to what is often believed, the former does consider companies’ impacts on the environment: “It is important to acknowledge that the enterprise value lens also includes any impacts that the entity may have on climate change that circle back to have a subsequent impact on the entity’s enterprise value. For example, if an entity has a significant negative impact on climate change, this may negatively impact its enterprise value due to subsequent regulatory action or social pressure.” The XRB added that in the TCFD framework, disclosures such as greenhouse gas emissions information are material.

The XRB’s argument seems to be that fear of a regulatory clampdown or a public opinion backlash converts the enterprise value approach into one that looks a lot more like double materiality. That would raise a number of thorny questions. Does it, for example, imply that there is an onus on regulators and the public to assume an activist role so that environmental harms have a significant cost to companies?

But Ms Hall too believes that there is some room for convergence. While the ISSB will initially only cover enterprise value, not double materiality, the interest in impact reporting from jurisdictions like the EU and UK will mean that “the ISSB is likely to consider ESG impact reporting as a key next step in the framework’s evolution”, she insists.