INTRODUCTION

Sustainability is on the agenda of most corporate boards today. Many companies take steps to embed sustainability in their strategy, operational systems and decision-making process. Globally, public demand for business transparency in respect of environmental, social and governance (ESG) issues has driven the rise of ESG reporting among companies across all sectors. In many instances, ESG reports are prepared in response to impending market regulation, investors’ requirements and peer pressure.

“GLOBALLY, PUBLIC DEMAND FOR BUSINESS TRANSPARENCY IN RESPECT OF ENVIRONMENTAL, SOCIAL AND GOVERNANCE (ESG) ISSUES HAS DRIVEN THE RISE OF ESG REPORTING AMONG COMPANIES ACROSS ALL SECTORS.”

In a changing world, a company’s ability to assess and mitigate risks related to climate change, human rights, biodiversity loss and supply chains will become a core part of an investor’s decision-making process, thus informing capital allocation. At the same time, ESG reporting faces problems associated with inconsistent metrics, unreliable ESG ratings and lack of independent verification. This article discusses the importance of bringing together corporate and market action, government and regulatory pressure, and the vigil of the public’s eye to ensure the delivery of the sustainability goals at a company and at national and global levels.

ESG AT A CROSSROADS

ESG, a concept prevalent in the investment community, can be defined as a broad set of environmental, social and corporate governance considerations “that may impact a company’s ability to execute its business strategy and create

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value over the long term”. In practice, ESG reflects the view that managing environmental and social topics is a governance issue for companies, a “proxy for the quality of their management teams”.3

The process of identifying, assessing, managing and reporting on ESG matters shifts the focus from short-term gains to long-term successful performance. Over the past few years, companies have experienced growing demand from investors, governments and civil society to disclose how they assess and tackle climate- and sustainability-related business risks. As a result of this call for disclosure, companies are providing more information about their ESG practices than ever before.

As an illustration, the proportion of S&P 500 companies that published a sustainability report rose to 92 per cent in 2020 from 20 per cent in 2011.4 This trend demonstrates that the business community is responding to the demand for transparency around ESG factors. The growing sophistication of such reports underpins the understanding that effective ESG integration is vital for risk management and identification of new business opportunities as countries move towards net-zero economies.

While investors increasingly rely on such disclosures to measure the sustainability of their portfolio, the growing number of disparate ESG reporting standards and frameworks continues to stir uncertainty about the accuracy and comparability of ESG data. Companies are often confused by how best to report on ESG progress in a credible way and avoid being accused of “greenwashing” or “greenwishing”.5 This ambiguity has defied the key pillars of reporting, which aim to provide coherent, comparable and useful non-financial information to investors and other stakeholders. With at least 34 regulatory bodies and standard setters in 12 markets undertaking official consultations on ESG in 2021 alone,6 there is no globally accepted set of standards.

Due to this lack of uniformity, many companies choose ESG metrics that are easily measured and consistent with their own aspirations and short-term growth trajectory. Accordingly, even though a growing number of businesses publish ESG reports, the contribution of their sustainability activities in averting the global climate crisis remains unclear. Some sustainability leaders and academics have lamented that reporting alone does not ensure environmental and social improvement and has become a means on its own.7 Effectively, studies show that individual corporate action alone, although important, is not sufficient to deliver on the global Sustainable Development Goals (SDGs) or allow business to grow within the boundaries of our finite planetary ecosystems.8

It is therefore important to distinguish between the concepts of ESG reporting and sustainability. ESG reporting is based on quantifiable metrics that aim to provide data to investors on how companies address non-financial issues in their operations (such as regard of human rights and carbon emissions) and how they manage ESG risks. A company’s ESG report is important to inform investors’ decision-making and redirect the flow of capital towards more sustainable business models.

Sustainability builds on this, but goes further by balancing a company’s ESG performance and its impact measured against internationally recognised standards, frameworks and best practices. This effectively goes deeper to the core of double-materiality, which is embedded in the
European Union’s (EU) sustainable finance package. The double-materiality principle recognises that a company should report on sustainability matters that are both material to its business and to the market, the environment and society. Sustainability has to be specific to individual sectors and companies and should be closely embedded in the company’s strategy.

Sustainability frameworks are intrinsically linked to the concept of sustainable development. To translate sustainability into practical solutions on the business level, we have mainstreamed it through ESG criteria. At the same time, ESG information on a company can prove abstract unless there is a robust policy framework, meaningful targets and a direction of travel. ESG reporting should rely on consistent, comparable and systematic standards and show progress towards clear corporate commitments. To ensure impact beyond individual companies, we need to draw on concepts such as science-based targets, nature-based solutions and net-zero pathways and secure broader engagement. The mobilisation of actors and solutions will provide the much-needed data, tools, independent verification, pressure and sanctions.

“IT IS IMPORTANT TO BRING TOGETHER CORPORATE AND MARKET ACTION, GOVERNMENT AND REGULATORY PRESSURE, AND THE VIGIL OF THE PUBLIC’S EYE TO ENSURE THE DELIVERY OF THE SUSTAINABILITY GOALS AT A COMPANY AND AT NATIONAL AND GLOBAL LEVELS.”

The 1987 Brundtland Commission, the 1992 Rio Earth Summit, the Rio Summit of 2012, the SDGs, the 2015 Paris Agreement, UNFCCC COP26 and other initiatives, fora and frameworks have driven the sustainable development agenda.
TOWARDS GREATER HARMONISATION AND REGULATION

The 2018 International Panel on Climate Change (IPCC) report warned that the carbon budget on our planet is running out. We are living in a critical decade when we can witness the devastation to communities and economies that climate change brings, while we still have limited time to avert the worst possible impacts. The February 2022 IPCC report has laid bare the urgent need to reduce global emissions and invest in adaptation measures to the physical impacts of a warming planet. Climate change, pollution and unsustainable business practices are taking a toll on the natural capital, contributing to a biodiversity loss that further accelerates climate change.

Since the Paris Agreement was signed, public support for an ambitious climate agenda has soared. The commitment to deliver on the climate goals has catalysed significant efforts among central and local governments, financial and business communities, and in civil society and professional organisations. This has driven the whole sustainability agenda as demand for measurable results has grown.

The role of governments and regulators in addressing market failures, pricing carbon and natural resources adequately, and requiring corporate transparency is essential to provide the necessary steer to corporate behaviour. Transparency rules and strict greenwashing regulations will help channel finance into sustainable activities.

Leading the way, the European Commission (EC) adopted an Action Plan on Sustainable Finance in March 2018, followed by a strategy in April 2021. This strategy laid out an ambitious and comprehensive package of measures to help improve the flow of money towards sustainable activities across the EU. This set of measures, which will be instrumental in making Europe climate neutral by 2050, consists of:

1) a disclosure framework for sustainability-related information, 2) investment tools, including benchmarks, standards and labels and 3) a classification system or “taxonomy” of sustainable activities.

The EU package therefore comprises several acts. These include a new Sustainable Finance Disclosure Regulation that defines the rules and principles for sustainable finance for financial market participants and financial advisers. This framework will be supported by the taxonomy, a green bonds regulation and sustainability risk requirements by financial regulators.

Furthermore, the EC has proposed a new Corporate Sustainability Reporting Directive (CSRD) that amends the Non-Financial Reporting Directive currently in force. The CSRD is built on the premise that ESG issues may have material impacts on an organisation, cements the double-materiality principle, changes reporting from voluntary to mandatory and subjects reporting to verification.

Under the proposal, the EC plans to extend the scope of reporting obligations to all large companies with more than 250 employees and all firms – including non-EU businesses – with securities listed on EU-regulated markets (except listed micro companies). This significantly increases the number of entities that will need to report in the EU from 11,000 under the Non-Financial Reporting Directive to almost 50,000 under the CSRD. In addition, the EC proposal for a directive on corporate sustainability due diligence would require businesses to audit their supply chains for adverse human rights and environmental impacts by implementing risk-based, robust and effective supply chain due diligence practices. The package of regulations

would require consistent sustainability reporting and responsible corporate behaviour of large companies and throughout their value chains.

The European Financial Reporting Advisory Group (EFRAG) is developing detailed sustainability reporting standards that will be issued as delegated acts.15 EU sustainability standards will closely follow Global Reporting Initiative requirements and will make mandatory reporting a very powerful benchmark to be used by investors and analysts.16

Overall, these measures form part of a broader suite of ESG initiatives to channel investments to environmentally and socially beneficial activities, far beyond the geographical boundary of the EU. Such initiatives aim at facilitating businesses’ alignment with both Paris Agreement climate targets and the United Nations 2030 Agenda for Sustainable Development.

Further convergence of existing standards and frameworks for ESG reporting is expected under the International Sustainability Standards Board (ISSB) set up by the International Financial Reporting Standard setter EFRAG (EFRAG).17 For the first time, there is consensus among the G718 and, to some extent, G2019 groups of nations on the need for consistent climate reporting in line with the recommendations of the Task Force on Climate-related Financial Disclosure and harmonisation of ESG reporting standards.20

WHAT IS SUSTAINABLE INVESTMENT?

As part of the reporting requirements, the EU and several other international players have been developing taxonomies to define what qualifies as a sustainable investment. This is important to reduce greenwashing and ensure that sustainability reporting is consistent, transparent and verifiable. The EU is developing a common language and a clear definition of what is sustainable by creating a classification system for sustainable economic activities, that is, the “EU taxonomy”.

The EU Taxonomy Regulation,21 which establishes the basis for the EU taxonomy, will require major financial actors and businesses in the European Union to report on their alignment with the criteria of the Taxonomy Delegated Act under the new disclosure regime (see above). An economic activity must meet four overarching conditions and six environmental objectives to qualify as environmentally sustainable. Work is ongoing on social taxonomy, which incorporates “Significant Contributions” and ensures “Do No Significant Harm” principles.

ENSURING BROADER ENGAGEMENT FOR IMPACT CREATION

The impact of the EU legislation on the financial sector will lead to increased availability and mainstreaming of ESG data. This will come with initial hurdles from preparing data collection. While most of S&P 500 and FTSE 100 companies have published comprehensive sustainability reports in recent years, many businesses in emerging markets are not yet ready to report in line with the evolving standards and frameworks. This has resulted in delays and confusion in ESG reporting.

Demand has been growing in the countries where the EBRD operates for guidance and technical support to develop frameworks, practices and regulations that would help unlock opportunities for sustainable finance. Accordingly, we work with private- and public-sector clients to invest in

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15 See EFRAG (2022), Draft European Sustainability Reporting Standards for consultation, Brussels (available at: https://www.efrag.org/.lab3).
16 The standards address a wide variety of ESG issues ranging from pollution prevention, diversity and corporate governance, and labour issues to climate and impact on local communities, supply chains as well as risk management.
17 The IFRS Foundation is the international body that governs the setting of global accounting standards that have been adopted by hundreds of jurisdictions around the world. Five leading standard and framework setters – the Global Reporting Initiative, the Sustainability Accounting Standards Board, the International Integrated Reporting Council, the Climate Disclosure Standards Board and the Carbon Disclosure Project – announced a shared vision in November 2020 for a comprehensive corporate reporting system that considers both financial and sustainability disclosure connected via integrated reporting, which is what ISSB is tasked with developing.
20 This approach is also consistent with the work of EFRAG on developing sustainability standards under CSRD.
green and sustainable products, provide training and capacity building, and help develop new laws, regulations and best practices.

The EBRD has committed to align all of its activities with the goals of the Paris Agreement by the end of 2022 and become a majority green bank by 2025. In line with its Green Economy Transition approach, the Bank has honed its unique business model (which combines investment, policy dialogue and advisory) to promote a green transition. We support policy initiatives that help our partners assess and integrate material ESG factors into the investment decision-making process.

For illustration, below we discuss how we work with stock exchanges in the EBRD region to raise capacity and help direct capital towards sustainable products and activities.

THE EBRD’S POLICY ENGAGEMENT WITH STOCK EXCHANGES

Stock exchanges play a strategic role in the shift towards more comprehensive ESG disclosure. They enable economic development by facilitating the mobilisation of financial resources and bringing together those who need capital to innovate and grow with those who have resources to invest. Many exchanges worldwide recognise such opportunities, as well as the related risks, and are stepping up their efforts to engage market participants and integrate ESG into mainstream financial practices.

As one of the largest investors in its region of operations, the EBRD launched a policy initiative in 2020 to help stock exchanges in the economies where we operate to navigate the various ESG reporting frameworks and requirements that have emerged over the past few years. Business communities in emerging markets have little awareness of this topic and there is a large gap in terms of tools, guidance and training for stakeholders. This initiative aims to close that gap by collaborating with stock exchanges and giving them the necessary materials to be able to educate issuers and investors on ESG.

In May 2021, the Warsaw Stock Exchange – a regional leader in terms of number of listed companies and market capitalisation – published the first ESG guidelines for listed firms developed with EBRD’s technical assistance. The guidelines are the first in Poland and Central and Eastern Europe to take into account the latest developments of the EU sustainable finance framework and good industry practices while also remaining reflective of the national context. Local companies and companies from the region, including Bank clients, have started incorporating the guide’s recommendations in their ESG reporting.

Similarly, on 31 January 2022, the Macedonian Stock Exchange (MSE) published its ESG guidelines, developed with the EBRD’s technical support. The first in North Macedonia and the Western Balkans region, these guidelines provide practical information for issuers on how to prepare their ESG reports.

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24 The authors would like to recognise the EBRD specialists who have worked together with them on this initiative from three different teams across the Bank (Legal Transition, Capital and Financial Markets Development, and the Environment and Sustainability Department); Lucija Baumann, Razvan Dumitrescu, Jacek Kubas, Florian Lalanne, Daniel Man and Viktorya Protsenko.

25 In 2009, the United Nations-backed Sustainable Stock Exchanges Initiative was launched to engage exchanges in the dialogue about how to promote better markets through sustainable business practices. Today, the initiative has 110 Partner Exchanges, 83 of which have published ESG reporting guides for their listed companies. See Sustainable Stock Exchanges Initiative (n.d.), “Stock Exchange Sustainability Activities” (available at: https://sseinitiative.org/).


In the same vein, in 2022 the Bucharest Stock Exchange\textsuperscript{30} published its first guide providing step-by-step guidance for ESG reporting prepared with EBRD support. The guide acts as a “bridge” between current practice in the local market and the ESG reporting expected to enter into force in the coming years under the proposed EU sustainable finance legislation and its accompanying standards.

**MARKET SHIFT TOWARDS A GREEN AND SUSTAINABLE FUTURE**

In light of the growing pressure for decarbonisation, investors are demanding a radical transformation of business models to manage ESG risks. Better company ESG performance is important for greening financial flows, creating long-term value and connecting with customers and employees. Thus, integration of ESG considerations in decision-making processes is quickly becoming good business practice.

The EBRD is committed to aligning all activities with the Paris Agreement on climate change, promoting the SDGs and supporting its clients and economies of operations in their green and climate transition. As we hurtle through the coming decade, businesses will see the Paris Agreement and the EU sustainable finance package transform from a guiding beacon to a mile-marker in the race to net zero. Limiting climate change and ensuring sustainability was always going to need more than a portfolio tilt, but the new reporting frameworks will create opportunities for companies and investors to change business models, develop effective transition pathways and consider their broader impact.

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