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ESG Mid-Year Review: Expectations for the Remainder of 2023

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ISSB Financial Reporting Standards

- The International Sustainability Standards Board issued its inaugural financial reporting standards at the end of June.
- These standards will be effective from January 2024 and are intended to assist in standardizing ESG data.

A wide range of market participants have worked together to respond to the demand for increasing ESG data and clear standards. The International Sustainability Standards Board (ISSB), formed by the International Financial Reporting Standards Foundation (IFRS), issued its inaugural financial reporting standards, IFRS S1 and IFRS S2, on June 26, 2023. At the London Stock Exchange Group plc's launch event for the standards, the exchange's CEO Julia Hoggett hailed this as a "landmark day for the global economy."

S1 is the "core baseline" of sustainability reporting and is designed to apply globally to corporates in all sectors to better unify disclosures on factors such as waste and emissions. It sets out how companies can integrate reporting and links sustainability with financial information. S2 details more specific topics such as climate mitigation and adaptation, and will build on existing disclosure frameworks.

ISSB Chair Emmanuel Faber stated that the standards are intended to cut through the "alphabet soup" that has hampered companies in the past few years, reiterating that the standards are not a suite of ESG metrics or disclosures but "a comprehensive language which is deemed to be consistent, verifiable and therefore decision-useful" for market participants.

Both S1 and S2 will be effective from January 2024 and corporate reports should align with the standards beginning FY 2025.

Challenges Facing ESG Rating Agencies

- The ongoing divergences between ESG rating agencies will remain a focus for U.K. and EU regulators in the second half of 2023.

Dissonance across the ESG ratings industry might soon be resolved after U.K. and EU regulators raised concerns about rating agencies' "opaque" practices. Currently, not only approaches, but

objectives, methodologies and indicators vary significantly, making it difficult for customers and investors to appreciate precisely what and how ESG metrics should shape investment decisions.

ESMA has described the market for ESG ratings as “immature” based on the structure and dispersion of methodologies.[4] A Stanford business school researcher has noted that the input variable between rating agencies is “massively large”[5]: FTSE Russell claims its model uses 300 indicators; Refinitiv uses 630 ESG metrics; and S&P Global uses 1,000 underlying data points. This lack of standardization at a high level is problematic for companies reporting the same information to different providers, as their scales are not directly comparable.

In a Dear CEO letter dated September 2022, the U.K.’s FCA set out perceived risks in providing ESG ratings. This letter’s sequel, “ESG Benchmarks Review,” dated March 2023, was harsher: It warned that benchmark administrators are fuelling greenwashing after identifying “widespread failings” with ESG benchmarks. The second letter signals that these ratings are rising to the top of regulatory priorities.

Efforts to improve their practices are underway in the market. MSCI, the index provider, changed its criteria for ESG labelling of ETFs in March 2023.[6] Most “physical” funds, which directly hold bonds and equities, saw their ESG ratings lowered, while the number of AAA-rated European ETFs was estimated to fall from 1,120 to 54, and the number with “no rating” was estimated to rise from 24 to 462. All “synthetic” ETFs, which use swaps to track the value of assets, were expected to have lost their ESG rating even if the funds that own the identical underlying asset were rated highly. MSCI explained that it would only rate synthetic ETFs once it has developed a method to rate consistently the data of the constituents of the underlying index being tracked, rather than the data of the swap collateral holdings. This is in contrast to Dow Jones’ ESG ratings, which are based on indices rather than funds, so a swap-based ETF will have the same rating as a physical one replicating the same index.

Granular divergence such as this, as well as the aforementioned broad brush concerns already raised by regulators, explain the rationale behind HM Treasury’s proposal for a regulatory regime for rating providers in the U.K. In the U.K., credit ratings agencies, like benchmark administrators, are regulated by the FCA, which has expressed support for introducing regulatory oversight of ESG data and rating providers specifically. In the meantime, a voluntary Code of Conduct for ESG data rating and agency providers, published on July 5, 2023 has been developed by an industry working group led by the FCA. The U.K.’s move is in tandem with EU sentiment: Draft EC proposals indicate that companies providing ESG ratings must explain their methodologies and obtain regulatory authorization to continue to provide these services.

In both jurisdictions, bringing ESG rating providers within the regulatory perimeter will involve consultation of the International Organization of Securities Commissions and likely adoption of its recommendations. Regulating ESG data and rating agencies in that way would harmonize expectations and practice, particularly where rating agencies might also be benchmark administrators. To encourage such uniformity would be to instill confidence in investors and consumers alike.

United Nations COP28

- The COP28 conference will be held in the United Arab Emirates in November 2023.
- The conference president has announced a focus on the reduction of emissions rather than the phasing out of fossil fuels, which has sparked complaints.

This year’s United Nations Climate Change Conference (COP28) is set to take place in the United Arab Emirates this November and, despite being nearly six months away, is already the subject of much debate. The appointed president of COP28, Sultan al-Jaber, is also the head of

the Abu Dhabi National Oil Company, and has stated that fossil fuels will continue to play a key role for the “foreseeable future.” This has resulted in a number of climate activists and stakeholders criticizing the conference before it has even begun as placing too much emphasis on fossil fuels, but others believe this may represent a more realistic approach to climate change.

As the halfway point of the commitments made under the 2015 Paris Agreement, COP28 will attempt to reassess the steps necessary to meet the treaty’s 2030 climate goals, which involve further reducing emissions by 43% to achieve the initial 1.5℃ reduction target. The preliminary policy agenda focuses on global climate finance, proposes a $100 billion fund to assist impoverished nations adapting to climate change, and stresses reducing emissions rather than phasing out production of fossil fuels. The outcome of COP28 and its implications for companies will therefore be interesting to see.

Download the complete memorandum here.