Business at OECD

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ESG (environmental, social, and governance) considerations are gaining traction among investors, policymakers, and other stakeholders and significantly impacting corporate practices. They inevitably require closer cooperation between public and private sectors to promote sustainable and inclusive economic growth.

This paper outlines business considerations on current ESG discussions, and reflects on the role that the OECD should play to address related business needs.

## What ESG means and why it matters to business

Investors increasingly incorporate values and concerns that go beyond financial performance in their decisions, combining three broad categories - 'environment', 'social', and 'governance'- into the concept of ESG. To gauge companies' efforts in addressing environmentally sustainable, ethical and corporate governance issues, they often refer to a set of non-financial performance indicators under this concept. They also expect to see preparers connect such non-financial information to financial information. For example, the ESG targets set by companies and their consistency with judgements and assumptions in the financial statements.

While this concept allows for a wide range of approaches, ESG investment practices generally saw rapid growth over the recent years - and we expect this trend to continue in the future. The OECD Business and Finance Outlook 2020 finds that globally almost USD 1 trillion of assets were held in sustainable funds at the end-of 2019 and expects that global ESG assets will exceed $53 trillion by 2025. The latter would represent more than a third of the $140.5 trillion in projected total assets under management, according to analysis by Bloomberg. As a result, the share of companies with ESG scores has substantially grown both by number and market capitalization. We can observe a similar trend in the corporate debt market as we see increasing issuance of green bonds over the last few years, reaching nearly EUR 750 billion in 2021.[1]

The rapid adoption of ESG in markets is driven by a variety of factors, such as an increasing interest from investors, and the need for fiduciaries to focus on sustainability considerations to meet their duties with shareholders and stakeholders. Companies are already required to report extensively on ESG in some regions and by so doing, they are determined to differentiate themselves based upon a strong performance on ESG metrics. Presenting a solid ESG performance not only prevents reputational damage, but also contributes to a differentiating factor and competitive advantage that can open up new business opportunities for long-term value creation.

Long before ESG came into being, many companies were pursuing objectives and implementing programs that today are categorized as ESG. The adoption of these programs was mainly because it improved their reputation and corporate values. Finally, both existing and anticipated regulatory developments mandating certain ESG practices also accelerated this trend.

## Key business considerations on the ESG discussions

Despite the growing public, private, and societal interest in ESG considerations, there are significant divergences in the degree to which countries developed related practices. As ESG discussions move forward, we identify four aspects that we believe are crucial to incorporate in ESG discussions:

### (1) Consistency and comparability of ESG data

The OECD Finance Outlook mentioned above emphasizes that ESG scores vary widely from one ESG provider to another due to differences in methodologies, metrics, weightings, as well as a level of subjective judgment behind ESG ratings. In the absence of global standards, the underlying data that companies provide can also differ significantly, adding to the lack of consistency and comparability of ESG scores. This has negative implications for decision-makers in both the public and private sector. It is crucial to improve the transparency of evaluation criteria and provide explanations on the methodologies that are used so that ESG rating providers' evaluation can be useful enough to improve various initiatives taken by companies.

### (2) Scope of sustainability reporting

With the rising demand for transparency on ESG practices, appropriate reporting and disclosure of non-financial information is key for reliable ESG analysis and to adequately evaluate their relevance to a company taking into account the cost of implementation.

Given global interest by investors and other stakeholders in this information and its importance to future capital flows, a harmonized, global system of corporate reporting for company reporting is needed.

After the COP26 meeting, we are starting to see the convergence to the ISSB (International Sustainability Standards Board) in terms of international sustainability reporting framework.[2] However, the definition of "sustainability reporting" remains a topic of controversy as different stakeholders have diverging views on what it means and where the boundaries of such reporting are.[3] Therefore, taxonomies would be another important aspect to consider when defining the very concept of "sustainability." Getting both the framework and taxonomy right will avoid a situation where different organizations apply their own ESG related sustainability reporting metrics and standards, which ultimately leads to potential inconsistencies and confusion.

Furthermore, users of sustainability reporting mechanisms are very diverse with different focus and needs, necessitating a certain flexibility of reporting metrics and standards. This makes it also very difficult to find consensus on what constitutes "appropriate" reporting.

### (3) Cost of implementation

Incorporating ESG considerations into business activities must be achieved with an acceptable balance between the costs/administrative burdens to ensure that it provides tangible benefits to companies. Furthermore, it is essential to avoid that reporting ESG standards becomes a 'greenwashing' or marketing tool, and that it generates insightful data.

In this context, it is important to emphasize that ESG reporting entails costs for all companies, both in terms of financial resources and administration. At the same time, cost burdens across different economies, industries or portions of a company's global supply chain must be taken into consideration to avoid a "one-size-fits-all" approach that neglects diverse characteristics of each country and sector.

### (4) SMEs

ESG considerations also concern Small and Medium Enterprises (SMEs). One significant challenge is ESG scoring bias, since current mechanisms tend to favor large-cap companies. This is reflected in the OECD analysis of ESG ratings compared to market capitalization, and a potential reason is that SMEs may lack the resources to invest in non-financial disclosure, and fear that the costs may outweigh the investment gains in the short term. They also face proportionately higher cumulative regulatory and administrative burden relative to their resources.

For some SMEs, the value and use of ESG information may be for internal decision-making. Relevant, timely, comparable and accurate ESG information can assist SMEs to think holistically about their strategy, business model and impact on the environment and society.

## How can policy address current challenges and what could be the role of the OECD?

Close collaboration and engagement with business is critical to address the aforementioned challenges. Hence, to contribute to the advancement of ESG discussions, we offer initial high-level considerations as to what policymakers and the OECD can do:

### (1) Find a common ground

Identifying "common ground" amongst stakeholders is a crucial first step to address taxonomy and data comparability issues. This requires a clearer and more coherent framework for sustainability reporting, which helps to prevent further proliferation of different reporting requirements and reduce regulatory burden from unnecessary complexity. However, when doing so, it is not necessary to start from scratch. Many existing policy standards and best practices can serve as a basis to formulate global and common ESG standards. For example, the EU taxonomy for sustainable activities attempts to list and classify what constitutes environmentally sustainable economic activities. As we previously pointed out in our "Key Messages on Efforts to develop sustainable finance definitions and taxonomies," market participants will need an approach to comply with disclosure requirements that are as simple and automated as possible to avoid bureaucratic burdens, as well as the effort to improve the data collection and data quality. At the same time, it is important to strike the balance between reducing fragmentation of definitions and taxonomies, and avoiding "one-size-fits-all" approach that neglects diverse circumstances of each country and sector.

The OECD can contribute to the ongoing efforts for convergence of existing standard-setters and other initiatives and by mapping and analyzing existing and proposed standards and frameworks including the International Sustainability Standards Board (ISSB), the Value Reporting Foundation, the Global Reporting Initiative (GRI), the Task Force on Climate-related Financial Disclosures (TCFD) and other regional reporting regulations like the Corporate Sustainable Reporting Directive (CSRD) of the EU and related European Sustainability Reporting Standards under European Financial Reporting Advisory Group (EFRAG). In addition, the OECD should use its close cooperation with other international organizations to support the global efforts for convergence and to achieve a globally-aligned corporate reporting system.

### (2) Making ESG standards accessible and inclusive

It is crucial that for business that ESG standards become as accessible and inclusive as possible. To this end, ESG standards should also reflect considerations as to how a business operates, as well as what metrics and other performance information are widely measured and used by companies (including sector-specific metrics). A major hurdle for many companies, particularly SMEs, is the implementation of data management systems, supported by an effective management system. There is a significant cost burden associated to that, which is an area where systems-level technology investments could be of service.

We also need to reflect the particularity of SMEs' needs as they account for the majority of companies globally. This would certainly bring leverage to the ESG efforts by the public sector: SMEs, which tend to have a closer link to the local communities and a more agile decision-making process than large corporates, can be a game-changer in promoting ESG if they receive due consideration and the reporting obligations are proportionate to their resourcing capacity and capabilities. Being inclusive to unlock their potential can therefore contribute to achieve ESG goals. To this end, it is important to ensure that ESG standards are accessible, affordable, flexible, and implementable for SMEs.[4]

The OECD can deepen its research to find a pathway that encourages SMEs to participate in the transition to ESG-conductive business ecosystem.[5] Clearly defined and communicated requirements would contribute to the accessibility of standards.

### (3) Transform ESG into a pro-growth agenda

Measures to tackle ESG issues should not be preventing business from taking on new challenges to foster global prosperity. Instead, ESG standards should underpin market-oriented policies that promote sustainable development for all businesses and industries. Hence, it is crucial to create an enabling environment for companies where addressing ESG issues can help the private sector to reduce their operating costs and increase productivity.

To this end, it is essential to promote an early and active involvement of the private sector in ESG-related developments and norms setting. ESG considerations can provide companies with a competitive edge, especially in time when consumer behavior is changing, and awareness for ESG issues is increasingly present in the global economy.

To conclude, the OECD should maintain a sound dialogue with the private sector with a view to identifying practical obstacles and enabling businesses to contribute to the double objective of fostering growth and prosperity in a sustainable, inclusive and responsible manner. Business at OECD (BIAC) stands ready to support the OECD on these matters and provide evidence-based policy advice reflecting on-the-ground realities to maximize the impact on the ESG approaches, while minimizing regulatory and legal constraints and promoting a proportionate, efficient and effective system.

[1] Source:

# Footnotes

1. ESG Finance Q4 and Full Year 2021 - European Sustainable Finance | AFME
2. CDSB has already converged into the IFRSF and VRF (SASB standards and integrated reporting) has committed to converge by June 2022.
3. Sustainability reporting may be to different users who have different needs. The debate is frequently characterized as 'outside-in' and 'inside-out' (impacts of ESG matters on a company, and the impacts of the company on people, planet and prosperity for society).
4. For instance, OECD MNE Guidelines are kept very broad and flexible with the idea in mind that they should only be applicable to smaller and larger multinational companies.
5. Cross-referencing existing ISO standards 9000, 14000, 26000, 45000 would also be useful. For example, the chemical industry has Responsible care ™initiative with maturity levels which helps SME size their efforts while identifying where they can best contribute.

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