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THE POLITICAL ECONOMY OF GREEN REGULATION

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Financial regulation is moving to a new and highly fraught political terrain, and it is colored green. Investors' demand for ESG investment products is booming. Banks and corporates, often pressured by their governments, are committing to redirect their focus towards less carbon-intensive activities. However, it is not clear that these private sector commitments are enough to achieve the transition needed; and given the uncertain regulatory environments, there are high risks of misrepresentation and greenwashing. This also has the potential to foster international rivalry, given the effects on the global allocation of capital that these regulatory reforms can have. The sustainable finance regulatory agenda therefore carries a significant risk of geoeconomic tension that could undermine cooperation and climate mitigation.

This policy brief seeks to clarify the contours of the green regulatory field and take stock of existing initiatives. It looks at the three major approaches to green regulation, explaining the philosophy underpinning each, and the emerging political dynamics between them. These three approaches are: (i) taxonomies (i.e. defining what economic activities are sustainable, and/or unsustainable, and/or what activities potentially fall in between), (ii) disclosure rules, and (iii) sustainability reporting standards (the latter two referring to standards compelling a private sector actor to disclose information, with varying degrees of detail, on the relationship between its activities, climate-related risk and other



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sustainability risks). These three approaches are not mutually exclusive. Each of them rests on a different philosophy, but in principle they complement each other by addressing different needs in the sustainability policy space or value chain.

This field is already a highly fragmented one. On all three fronts, there is a variety of existing approaches and actors. In addition, while these three approaches are not mutually exclusive, some actors or countries are positioning themselves as, or in some cases being perceived as, the champions of one approach versus another. This fuels the competition between major jurisdictions involved (the EU, the US, the UK, China), who all have a strong interest in being global standard-setters on sustainability related-matters given the potential geoeconomic implications.

Discussions at the G7/20 level this year, in particular between the US and the EU, are central to achieving some level of international cooperation in this field, ideally on all three pillars. This is essential to enable the fastest possible energy transition and ensure that the current proliferation of approaches and standards does not create growing opportunities for international regulatory arbitrage and greenwashing.

The prescriptive approach: the taxonomy

The first approach to green financial regulation consists in creating a classification of economic activities according to their sustainable, or unsustainable, character (ie. a taxonomy). There can be multiple intended uses for such a tool, across government, the financial sector and corporate sector. In particular:

- > It can encourage public and private investment towards sustainable economic activities, thus creating, strengthening and/or deepening capital markets associated with them. For instance, the first taxonomy finds its roots in China, where the booming green bonds market (China is one of the largest green bonds issuers in the world) led the People's Bank of China to create a



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“green bond endorsed project catalogue in 2015, often referred to as the Chinese taxonomy”¹.

- > Conversely, it can identify greenwashing investments and initiatives, whether initiated by private actors or governments.
- > It can be incorporated into prudential regulation of financial institutions, in order to encourage the financial system to align its balance sheet with activities supportive of climate safety or transition activities (e.g., by introducing additional, penalizing capital requirements if a bank continues to finance unsustainable activities).
- > It can also be incorporated into public financial management, in order to help track the climate impact of national budgets, especially public expenditure. This fosters transparency and accountability. It also helps countries connect their medium- or long-term commitments to reducing emissions or achieving net-zero emissions with their short-term spending and planning.

“Taxonomies are a highly normative approach to green regulation... the European Union positioned itself early on as a leader on this topic, but it is unclear to what extent this European leadership potential can fully materialize.”

Taxonomies are a highly normative approach to green regulation, and the philosophy underpinning them is that public bodies (central banks, legislators and regulators) have the responsibility to push down prescriptive standards on all economic actors and, ultimately, move financial flows towards sustainable economic activities. Precisely because it is normative, this approach is complex and fraught with political difficulties, because the public authority in charge of elaborating the taxonomy needs to take rather binary decisions about sustainability and the path to sustainability. In particular, two major questions pertain to what is being defined, and how these definitions are built:

- > Should a taxonomy only define (green) activities that are Paris-aligned and deemed sustainable, or should it also look into classifying other activities as unsustainable or transitional, and what kind of economic repercussions do these choices imply? For instance, the European Union chose to build a taxonomy of sustainable activities, defined according to two major criteria (to be deemed sustainable, activities must meet specific criteria demonstrating that they make a substantial contribution to at least one of the EU’s climate and environmental objectives, while doing no significant harm to any of its other objectives). Early in the process of elaborating this

¹ OECD, *Developing Sustainable Finance Definitions and Taxonomies*, October 2020.



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taxonomy, this approach was criticized by former Bank of England governor Mark Carney, who qualified this approach as binary, and noted that “mainstreaming sustainable investment calls for a richer taxonomy - 50 shades of green”². Eventually, the EU chose to include a few transitional activities in its approach, and is working on a more comprehensive approach to transitional activities. Other countries (Japan, Canada) have created taxonomies (Japan, Canada) that include “transition activities” in an attempt to avoid the binary approach of a taxonomy focused on sustainable and/or unsustainable activities. The UK is also said to be considering a taxonomy that includes transition activities.

- > Creating a taxonomy involves judgement calls - political choices - on complicated questions where science may not be able alone to give an indisputable answer (e.g., nuclear power). This does not necessarily delegitimize the resulting taxonomy, but raises fundamental questions about the transparency, accountability and democratic nature of choices made. This necessary discretion is one of the major reasons why establishing a common global baseline for taxonomies would require intense negotiations.

A number of jurisdictions have created or are creating taxonomies. They all look different and have different intended uses. Beyond the European Union, China, Japan, Russia, Canada, a number of Asian and Latin American economies, have established or are working on establishing taxonomies of some kind.

The European Union positioned itself early on as a leader on this topic (even if it wasn't the first mover), with clear ambitions of leveraging its taxonomy to become the global standard-setter in green regulation. The opportunity to play a global role was augmented by the Trump's administration being disinterested in international coordination in general, and in sustainable finance in particular. As a result, on 18 October 2019, on the margins of the International Monetary Fund (IMF)/World Bank annual meetings in Washington DC, the European Union launched, along with Argentina, Canada, Chile, China, India, Kenya and Morocco the **International Platform on Sustainable Finance (IPSF)**. The US, notably, did not join the IPSF (although its geographical scope has continued to grow since its launch³). Shortly thereafter, the EU established a working group, which it co-chairs with China, with the goal of identifying common ground amongst the world's existing taxonomies - work which could ultimately serve as the basis to create a global framework for taxonomies. The report on this work is expected to be published during the second half of 2021. On July 6th, 2021, the EU published its Strategy for financing the transition to a sustainable economy⁴. It contains a

² CARNEY Mark, “**Fifty Shades of Green**”, *Finance & Development*, December 2019, vol. 56, no. 4.

³ Since its launch, the eight initial IPSF members were joined by an additional 9 jurisdictions/countries: Hong Kong, Indonesia, Japan, New Zealand, Norway, Senegal, Singapore, Switzerland and the UK.

⁴ European Commission, **Strategy for financing the transition to a sustainable economy**, 6 July 2021.



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section titled “Promoting an ambitious consensus in international forums”, which confirms the EU’s ambitions to become a global standard-setter on taxonomies, but also on green financial regulation more broadly. It notes, importantly, that “the EU is actively engaging in the G20 and the International Platform on Sustainable Finance to avoid fragmented approaches”.

Three recent developments constitute positive signals for the EU:

- > In December 2020, the Hong Kong Monetary Authority’s Green and Sustainable Finance Cross-Agency Steering Group announced it would “aim to adopt the Common Ground Taxonomy” co-developed by the EU and China in the context of the IPSF⁵.
- > At the early June 2021 “Green Swan” conference hosted by the Bank on International Settlements, Chinese central bank governor Yi Gang stated that the Chinese and EU taxonomy were roughly 80% similar⁶.
- > In the UK, a new independent expert group, the Green Technical Advisory Group (GTAG), was established early June 2021 to oversee the creation of a UK taxonomy, with the goal of making significant progress on this before the COP26 scheduled in November 2021 in Glasgow. While its principles and remit are in the process of being defined, it appears that the EU’s taxonomy work is being leveraged to guide the UK taxonomy.

It is unclear, however, to what extent this European leadership potential can fully materialize, for several reasons.

First, the EU taxonomy was legislated in the form of a Taxonomy Regulation⁷ largely informed by the work of a Technical Expert Group (TEG) over the course of 2018-2020⁸. The TEG’s work on the Taxonomy also largely guided the European Commission’s work on the Taxonomy Delegated Act (DA). However, this process was mired in controversy, and affected the credibility of the EU taxonomy as a result. Indeed, negotiations around the DA (which was finalized in April 2021 - see the text [here](#)) suggested that the EU allowed special national

⁵ Hong Kong Monetary Authority, “Cross-Agency Steering Group Launches its Strategic Plan to Strengthen Hong Kong’s Financial Ecosystem to Support a Greener and More Sustainable Future”, 17 December 2020.

⁶ Bloomberg News, “China to Make Climate Information Disclosure Mandatory”, 4 June 2021.

⁷ A political agreement on the Taxonomy Regulation was reached in December 2019; the **final text** was published in June 2020.

⁸ Since then, the Technical Expert Group has been disbanded and replaced by the Platform on Sustainable Finance, which is working on additional components to the Taxonomy, including additional environmental, social themes and unsustainable activities.



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and/or corporate interests to significantly influence the negotiation process⁹. The goal of the DA was to specify technical screening criteria for climate change adaptation and mitigation under the Taxonomy Regulation.

Second, after strong initial pushback, the US is now sending ambiguous signals regarding the need for an international framework for taxonomies.

It is not clear on what terms the US is approaching this issue or how far it is willing to go in creating a global baseline for taxonomies. The extent to which the US may seek to build on, or integrate, the EU's work on taxonomies, is not clear either:

- > In March 2021, in the context of his European tour, US Special Presidential Envoy for Climate John Kerry met with French Finance Minister Lemaire. In response to Lemaire's proposal that the US adopt a taxonomy "identical" to the EU one, John Kerry unsurprisingly pushed back. He noted that while "it would be imperative for the US to weigh in, either with its own taxonomy (...), or obviously work with other countries", "the US has strong feelings about not having excessive regulation"¹⁰. At the time, this seemed to suggest that a taxonomy was unlikely to be taken on by the US, confirming the view that such a prescriptive policy-making approach was not in line with a US focus on market-driven policy approaches. This view was and remains held, despite the fact that following the Great Financial Crisis, the US did engage in highly prescriptive policy-making, in particular through the creation of the Volcker Rule, (which sought to define speculative market activities and shares common traits with the logic of the EU Taxonomy¹¹).
- > There was an evolution soon after in the US tone on this issue. In April 2021, on the margins of President Biden's Leaders Summit, Janet Yellen gave a speech at the Institute of International Finance suggesting the US might drive

⁹ The controversy focused in particular on natural gas. The Technical Expert Group elaborated a proposal that the European Commission accepted, and that included a strict emissions threshold on this activity. However, in the final weeks prior to the finalization of the Delegated Act, this threshold, as well as the way natural gas activities were described, were challenged by some Member States and Members of European Parliament, in the hopes of creating loopholes. This led to significant counter-pressure from civil society. The final text of the Delegated Act maintained original emissions thresholds but added wording that opens the door for potential future adjustments; this was also true for nuclear power. In addition, another controversy centred on forestry and bioenergy, with the Delegated Act adjusting the emissions thresholds proposed by the Technical Expert Group. This was denounced by civil society as a departure from the Commission's science-based approach.

¹⁰ HOOK Leslie, "John Kerry warns EU about carbon border tax", *Financial Times*, 12 March 2021.

¹¹ The Volcker Rule is a highly complex piece of US regulation, but essentially sought to define what constitutes proprietary trading or speculation versus not. Similarly to the EU Taxonomy (which seeks to define green around two tests, do no significant harm and contributing to at least one EU environmental goal), the basic principle of the Volcker Rule is built around two tests (strikingly similar in principle to the those in the EU Taxonomy) pertaining to types of market activities. And similarly to the Volcker Rule, which operationalized these tests around metrics, the EU Taxonomy operationalized its double test around thresholds.



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this topic into the G20¹² - and specifically into the G20's Sustainable Finance Working Group, which it co-chairs this year with China. It is now being said that the United States might consider elaborating something akin to a taxonomy, although again, its intent and potential contours are entirely unknown at this stage. Janet Yellen's remarks at the IIF came right off the heels of remarks made by People's Bank of China governor Yi Gang two weeks prior, suggesting that the work on creating an internationally harmonized framework for taxonomies would be discussed at the G20 Leaders Summit in October¹³.

- > Most recent developments confirm the ambiguity on this entire matter. G20 Finance Ministers met in Venice on July 9th and 10th 2021. The **G20 communiqué** published on this occasion confirmed that its Sustainable Finance Working Group was due to hand in a Synthesis Report and a multiyear G20 roadmap on sustainable finance, with a climate focus, before the G20 Finance Ministers' meeting in October 2021. On July 27, the Sustainable Finance Working Group met and gave more detail¹⁴ on the themes that will be tackled in both the Report and the Roadmap. It notes that the former will discuss "improving the comparability, compatibility, and interoperability of approaches to align investments with sustainability goals", and that the latter will focus on five key areas, including "market development and approaches to align investments to Sustainability Goals". This does seem to point to a discussion on taxonomies, but the question is whether this Working Group of the G20 will emerge with a recommendation or move towards a common framework for taxonomies. The statement made by Janet Yellen on July 11th at the Venice International Conference on Climate Change, held right after publication of the G20 communiqué, also uses ambiguous language to discuss this¹⁵.

A discussion on a common global framework for taxonomies at the G20 would be a very positive development and proof of European success in the external projection of its taxonomy agenda - if, and this is an important caveat, this

¹² "I am pleased that Treasury is co-chairing the newly relaunched G20 Sustainable Finance Working Group. (...) The Working Group will also coordinate approaches to identifying investments as climate-aligned or sustainable. This is an effort to counter another potential market friction—the rise of different policies and approaches across the world creates the potential for inconsistencies that lead to market fragmentation, distorting markets or impeding the flow of capital. See YELLEN Janet, **Remarks to the Institute of International Finance**, 21 April 2021.

¹³ LI Selena & YU Robin, "**China reveals cooperation with EU on green investment standards**", *Financial Times*, 7 April 2021: "Yi said deepening international co-operation on green finance, including discussing details on the adoption and incorporation of a globally recognised green taxonomy would be discussed at the upcoming G20 summit, which is scheduled to be held in October in Rome".

¹⁴ **Third Meeting of the G20 Sustainable Finance Working Group (SFWG)**, 27 July 2021.

¹⁵ "The Working Group will explore the various tools and approaches used by jurisdictions and the private sector to align finance with climate and sustainability goals and develop recommendations to enhance how they work together." See YELLEN Janet, **Remarks by Secretary of the Treasury Janet L. Yellen at the Venice International Conference on Climate**, 11 July 2021.



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discussion bases itself off the work the EU and China have already done together in the context of the IPSF. The EU itself notes, in its above-mentioned *Strategy for Financing the Transition to a Sustainable Economy* (see footnote 4), the importance of coordinated engagement between the IPSF and the G20. It also notes that the IPSF is “recognised as a knowledge partner to the re-established G20 Sustainable Finance Working Group”.

“Many open questions remain regarding forthcoming dynamics on taxonomies... What is clear is that at this stage, there is limited international coordination on the matter”.

As a result, many open questions remain regarding forthcoming political dynamics on taxonomies and whether or how this discussion will progress in international fora. In particular, between the G20 Working Group it co-chairs with the US and the IPSF Working Group it co-chairs with the EU, what are Chinese intentions? Will the existing work done by the IPSF serve as the basis for discussions in the G20 Working Group, knowing that the US is still not an IPSF member? Will US leadership translate into a significantly less ambitious international framework than what the EU would have proposed and therefore hollow out the global taxonomy work entirely? How will other countries, in particular the UK and Japan - both of whom have expressed interest in the taxonomy issue and its international harmonization - position themselves on this? Developments in the UK, especially ahead of the COP26 are occurring rapidly and are a space to watch.

What is clear is that at this stage, there is limited international coordination on the matter. In addition to the G20, the recent communiqué¹⁶ published by G7 Finance Ministers - a more like-minded group of policymakers - made no mention of the word “taxonomy” and of the need to elaborate internationally coordinated norms to define sustainable and/or unsustainable economic activities but the debate lives on.

Transparency, flexibility and market-driven adjustments: sustainability frameworks for disclosures

The second dominant approach to green regulation is one rooted in the importance of developing disclosure frameworks both by the financial sector

¹⁶ G7 Finance Ministers and Central Bank Governors Communiqué, 5 June 2021.



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and the corporate sector. The goal is to develop a general and principles-based framework that can be used by all types of companies to disclose information to the market, mainly about how climate risk is being managed by a company.

There are two logics to this approach. The first is to be able to assess and quantify climate-related risks, in particular for the financial sector, so as to allow adequate stress-testing or supervisory action, thereby safeguarding financial stability. The second was to provide information to the market so that it can adequately price both risks and impacts, and orient capital accordingly.

The fundamental belief is that transparency and disclosures will enable the price signals and necessary market adjustments towards sustainable companies and activities, by steering investment flows to those companies that integrate climate risk in their business model, governance and corporate processes, incentivizing companies to deal with climate-risk more fully and sophisticatedly.

In 2015, the Financial Stability Board (FSB)¹⁷ created the Task-force on Climate-related Financial Disclosures (TCFD) to develop voluntary disclosure guidelines for use by companies in all sectors. The Bank of England played an instrumental role in guiding the TCFD's work and recommendations and helped promote it as an internationally accepted standard, as Mark Carney was concurrently Governor of the Bank of England and Chairman of the Financial Stability Board. Its final disclosure guidelines are structured around four broad pillars. The guidelines encourage companies to disclose relevant metrics and targets, as well as information on how climate risk is incorporated into governance, strategy, and risk management.

Today, the TCFD is the dominant player in the field of disclosures. As of September 2020¹⁸, TCFD recommendations were followed by over 1,500 companies globally. It has garnered support from a number of governments (including France, Canada, Japan, the UK). Notable examples include:

- > The UK. In November 2020, UK authorities published a **Roadmap towards mandatory climate-related disclosures**, setting out an indicative path towards mandatory disclosures across the UK economy up to 2025.
- > France. In Paris in December 2020, following mounting political pressure on the margins of the One Planet Summit, the 40 largest French companies

¹⁷ The FSB is an international body that monitors international financial stability and formulates recommendations to that end, often acting on mandate of the G20.

¹⁸ See the TCFD [September 2020 Status Report](#).

listed in the “CAC 40” index, formally declared their support to the TCFD framework¹⁹.

- > New Zealand. While the TCFD set out its recommendations to be adopted on a purely voluntary basis, the government of New Zealand introduced legislation in April 2021 making climate-related disclosures aligned with TCFD mandatory for certain financial services organizations.
- > Singapore. Earlier in August 2021, the Singapore Exchange Regulation proposed a “roadmap for climate-related disclosures to be made mandatory”, and noted it wanted “issuers to make disclosures based on the recommendations of the TCFD”²⁰.
- > The TCFD approach is also supported by the Network on Greening the Financial System (NGFS), which encourages companies issuing public debt or equity to disclose per TCFD guidelines. Most central banks are now party to the NGFS and as such help promote the TCFD as a global standard.

The G7 Finance Ministers meeting discussed above confirmed the TCFD framework’s status as a global reference. The communiqué notes the G7’s support for “moving towards mandatory climate-related disclosures (...) based on the TCFD framework”.

The EU’s relationship to TCFD is more complex, but relevant EU texts now incorporate TCFD guidance. Indeed, in keeping with its ambition to champion green financial regulatory issues at home and abroad, the EU has created what can be seen as a complete ecosystem of green regulation, spanning the taxonomy, disclosures and reporting standards (the latter approach, and the subtle distinction between disclosures and reporting, will be discussed in the last section). It has therefore established its own texts that straddle both disclosures and reporting obligations - one for financial institutions (the Sustainable Finance Reporting Directive or SFRD) and one for corporates, which will be discussed in detail below (the Non-Financial Reporting Directive or NFRD, which was finalized before the TCFD approach was elaborated, and which is currently being revised and under negotiation; it will be known in the future as the **Corporate Sustainability Reporting Directive** or CSRD). The EU’s approach to disclosures and the TCFD approach were rooted in different concerns: financial stability for the latter, Corporate Social Responsibility for the former. The EU did strive, however, to provide guidance on how to disclose against both frameworks, but with rather weak results. The upcoming Corporate Sustainability Reporting Directive (CSRD) does encompass more clearly the TCFD approach.

¹⁹ The official press release, published 12 December 2020, is available [here](#).

²⁰ Singapore Exchange Regulation, *Consultation Paper on Climate and Diversity*, 26 August 2021.



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However, despite the general acceptance of the TCFD approach globally, it is possible that the US would choose to forge ahead with its own approach on disclosures. Such a decision would likely be politically contentious, and could induce market fragmentation. In a speech given on July 28th, 2021, SEC Chairman Gary Gensler discussed the SEC’s work on new rules that would require SEC-registered actors to disclose climate-related risk information. The SEC had solicited comments on this topic earlier in the Spring of 2021, in a consultation that mentioned and acknowledged the TCFD approach. In his speech, however, Gary Gensler noted that “we should move forward to write rules and establish the appropriate climate risk disclosure regime for our markets, as we have in prior generations for other disclosure regimes.”²¹

The materiality concept, a potential bridge between a market-driven approach and taxonomies? Sustainability accounting standards

The discussion on disclosure frameworks and emergence of the TCFD have forced and accelerated a discussion on sustainability reporting standards.

Disclosure frameworks and sustainability accounting standards can be seen as going hand in hand, or as overlapping. It is difficult to differentiate disclosure frameworks from sustainability accounting standards, but the proliferation of voluntary initiatives in this field has forced actors to draw lines in the sand. The Sustainability Accounting Standards Board’s attempt at differentiating both consists in considering disclosures as broad guidelines, whereas standards would be more detailed and specific²². The overlap between the two echoes certain debates that have taken place between regulatory requirements and accounting standards for the financial sector in the past (IFRS 9 for example). They reflect the interests of different stakeholders looking at similar concerns through different lenses, but they matter because these stakeholders are not equally equipped to collaborate internationally. Indeed, accounting standard setting bodies have engaged over the decades in international debates and

²¹ S&C Memo, *SEC Chair Addresses Details of Potential New U.S. Climate-Related Disclosure Rules*, July 29, 2021.

²² “It’s important to distinguish between sustainability frameworks and sustainability standards. Frameworks provide principles-based guidance on how information is structured, how it is prepared, and what broad topics are covered. Meanwhile, standards provide specific, detailed, and replicable requirements for what should be reported for each topic, including metrics. Standards make frameworks actionable, ensuring comparable, consistent, and reliable disclosure. Frameworks and standards are complementary and are designed to be used together”. See the official website of the Sustainability Accounting Standards Board, [this page](#) specifically.

convergence²³ while supervisory bodies (for example the SEC) have historically had a much more national bent.

One key question that has been structuring the debate on sustainability accounting standards - and that various actors involved in this debate have positioned themselves differently on (see below) - is that of materiality.

Materiality is an accounting concept that identifies the type of information that is deemed important or “decision-useful” for the company itself, the business sector it operates in, and investors²⁴. According to the International Accounting Standards Board, information is deemed material if “omitting, misstating or obscuring it could reasonably be expected to influence the decisions that the primary users of general purpose financial statements make on the basis of those financial statements”²⁵. The key tension here is the scope of thinking and the stakeholders involved.

“The materiality debate is key... where taxonomies do not exist yet, sustainability reporting standards may weaken or strengthen the case for them depending on the materiality approach retained”

In the case of sustainability accounting, the question is, do existing initiatives incorporate single, dynamic, or double materiality?

- > Single materiality looks at climate change’s impact on an individual firm’s risk profile and finances;
- > Double materiality looks, in addition to the above, at a firm’s *own* impact on the environment and other sustainability factors, including social factors;
- > Dynamic materiality is a forward-looking concept, recognizing, that “what is financially immaterial to a company or industry today can become material tomorrow”²⁶. As described by Donato Calace, dynamic and double materiality are interrelated: the latter acknowledges that materiality incorporates both financial and non-financial issues, i.e. a company’s impact on people and the planet is an information deemed material now. The former acknowledges that while a company’s detrimental impact on certain social issues may not

²³ For a brief history, see [here](#). For a more precise account of post-Great Financial Crisis debates, see [here](#).

²⁴ CALACE Donato, “**Double and Dynamic: Understanding the Changing Perspectives on Materiality**”, SASB Guest Blog, September 2020.

²⁵ This amended definition of materiality was introduced in 2018. See [here](#).

²⁶ World Economic Forum White Paper, in collaboration with the Boston Consulting Group, *Embracing the New Age of Materiality. Harnessing the Pace of Change in ESG*, March 2020.



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be financially material now, this may well be the case down the road; and in the case of climate change, this has materialized very rapidly.

The materiality debate is key. Indeed, it is clear that taxonomies need disclosure and reporting frameworks to become operational. But where taxonomies do not exist yet, sustainability reporting standards may weaken or strengthen the case for them depending on the materiality approach retained. Reporting standards rooted in single-materiality do not require a taxonomy of sustainable activities, or range thereof, to function, as single-materiality does not seek to look at a firm's climate impact. Double-materiality, however, based on how it is translated in reporting obligations, can arguably provide the hook justifying the need to develop a taxonomy of sustainable or unsustainable economic activities. Coming back full circle, the question of what private sector information is deemed material and needs to be reported on could strengthen or weaken the case for prescriptive efforts driven by policy-makers to create labels for what is green and what is not - i.e. taxonomies. For instance, for a company to be able to assess its own impact on the people and the planet in the context of an ambitious double-materiality framework, it would need definitions for what does or does not harm the environment. In the case of reporting standards rooted in single-materiality, they are likely to come across as alternatives to taxonomies, whereas those rooted in double-materiality are a complement to taxonomies.

The politics in this field are developing very quickly:

- > The European Commission adopted on 21 April 2021 a [proposal for a Corporate Sustainability Reporting Directive \(CSRD\)](#), amending the existing reporting requirements under the EU's Non-Financial Reporting Directive (known as NFRD). The proposal introduces a reporting requirement according to mandatory EU sustainability reporting standards. Very logically, considering its taxonomy push, the CSRD relies on a double-materiality approach. In addition, the European Commission has requested that the European Financial Reporting Advisory Group (EFRAG) prepares technical work and contribute to the European delegated acts through which sustainability reporting standards will be adopted²⁷. The EFRAG advises the European Commission on the endorsement of international accounting standards (International Financial Reporting Standards or IFRS; in [EFRAG's own words](#), it considers whether these standards "serve European public interest" and whether their endorsement would be "conducive to the European public good"). There is little doubt that the European Union is seeking to create a comprehensive sustainability ecosystem, addressing all

²⁷ EFRAG Press Release, "[EFRAG welcomes its role in the European Commission's Proposal for a new CSRD](#)", 21 April 2021.



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actors, needs and possible tools along the value chain, from a taxonomy to detailed reporting standards, and that its goal is to export this effort abroad. In the words of Valdis Dombrovskis, Executive Vice-President of the European Commission, “by developing European standards, we will build on and contribute to international initiatives.”²⁸

- > Five major organizations and initiatives provide different frameworks for sustainability standards, some of them structured along double materiality, others along what comes closer to dynamic materiality. These actors have published in September 2020 a *Statement of Intent to Work Together Towards Comprehensive Corporate Reporting* and consider that together, they provide a “nested ecosystem” (in their own words) of sustainability reporting. These organizations are:
 - the SASB mentioned above, the International Integrated Reporting Council (IIRC) and the Climate Disclosure Standards Board (CDSB). These organizations incorporate dynamic materiality, addressing reporting on a subset of sustainability topics deemed material for enterprise value-creation (which is forward-looking). In November 2020, SASB and the IIRC announced their merger to form the Value Reporting Foundation; it was completed in June 2021²⁹.
 - The Global Reporting Initiative (GRI) and the Carbon Disclosure Project (CDP), both of which incorporate double-materiality, explicitly requiring reporting on a company’s impact on the people, planet and environment.
- > The newcomer in the field of sustainability reporting is the IFRS Foundation, backed by the UK. Until now, the IFRS Foundation was focused on traditional financial accounting standards, setting standards globally recognized and adopted. In May 2020, the IFRS Foundation announced it would explore its potential role in creating global sustainability reporting standards. In February 2021, the IFRS Foundation published a *statement* that it may announce “the establishment of a sustainability standards board at the meeting of the United Nations Climate Change Conference COP26 in November 2021.” It became known in the Spring of 2021 that the UK - who holds both the G7 and COP26 presidencies this year - was actively pressing other G7 countries (in the context of the G7 Finance Ministers track) to adopt a formal communiqué officially mandating the IFRS Foundation to develop sustainability reporting standards. This was actively resisted by some European members of the G7, France first and foremost. First, because of the multiplicity of actors already active in this field - including their own Commission and EFRAG. Second, because the IFRS can be perceived by the

²⁸ European Commission Press Release, “**Sustainable Finance and EU Taxonomy: European Commission takes further steps to channel money towards sustainable activities**”, 21 April 2021.

²⁹ COHN Michael, “**SASB and IIRC complete merger to form Value Reporting Foundation**”, *Accounting Today*, 9 June 2021.



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EU as unfavorable to European corporates (hence the creation of the EFRAG). And third, the suspicion was that the IFRS Foundation would develop standards on the basis of single materiality, thereby weakening the case for taxonomies as an essential sustainable finance tool.

On June 5th, G7 Finance Ministers adopted strong language on sustainability reporting:

- > The language focuses on the IFRS, legitimizing this institution as the reference point for developing global sustainability reporting standards.
- > However, the language softens fragmentation risk, by the recognition that the IFRS would be developing a baseline, “which jurisdictions can further supplement”. It also called on the IFRS to involve a wide range of stakeholders, to “accelerate convergence”.
- > The question of double-materiality is addressed in the communiqué but remains completely open: it is recognised as an area of growing demand, but leaves open the question of what the “best approach” is.

Conclusion and recommendations

Addressing the challenge of climate change at the proper speed requires the highest possible ambition in addressing greenwashing and fragmentation risks, and reorienting all types of flows towards sustainable activities. It seems unlikely that markets alone can steer the quantum leap required to reorient existing socioeconomic structures towards a more climate-safe model. Ideally, what should be achieved is ambitious cooperation on all three pillars, i.e. taxonomies, disclosures and reporting standards. A more realistic goal would be the creation of common minimum global guidelines.

In this context, and considering the positions of the major players involved in this field, three major conclusions and recommendations emerge:

- > **One, the EU should leverage its alignment with China on taxonomies to push for a global conversation on this issue in 2021.** China and the EU have cooperated closely on this matter in the context of the International Platform on Sustainable Finance. At the same time, it is unclear how taxonomies will be featured in the October report of the G20’s Sustainable Finance Working Group, which is co-chaired by the US and China. The EU should leverage the coordination achieved with China on this matter to ensure, at a minimum, that the issue of creating a global baseline for taxonomies is addressed by the report, and at best, that this issue is addressed on the basis of the work



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already done by the EU and China through the International Platform on Sustainable Finance.

- > **Second, individual EU Member States should leverage their diplomatic engagement with the US and cooperation channels with the US Treasury, to encourage the US on the topic of taxonomies.** At minimum, they should encourage the US to clearly take on the issue of global coordination on taxonomies in the context of the G20, as discussed above. Ideally, and as a result of this diplomatic engagement, the US should also join the International Platform on Sustainable Finance. This would provide a strong and positive signal that after 4 years of absence on these issues, the US is ready not just to engage on these issues, but to do so with a clear intent of maximum cooperation.
- > **Finally, regarding reporting standards, EFRAG and like-minded standard-setters should continue to make the case for double-materiality.** A global baseline for reporting standards rooted in double-materiality will be needed as a complement to disclosure rules. In the meantime, as the IFRS Foundation works on the creation of a global sustainability reporting baseline, it should strive to integrate all the work already done in this field. At minimum, the IFRS Foundation should map out the way reporting standards fit with one another, and conduct an open process in the elaboration of its own standards. At the moment, it is clear that the IFRS Foundation is not moving towards an approach rooted in double-materiality. It should nonetheless fully recognize the importance of this debate, and propose conducting a review process of its reporting standards two years after these have been finalized in order to possibly update its approach.

About E3G

E3G is an independent climate change think tank accelerating the transition to a climate-safe world. E3G builds cross-sectoral coalitions to achieve carefully defined outcomes, chosen for their capacity to leverage change. E3G works closely with like-minded partners in government, politics, business, civil society, science, the media, public interest foundations and elsewhere.

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