The emerging sustainability information ecosystem

Key actions to take in the move toward decision-useful, trusted sustainability information

July 2022
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In the run-up to last year’s COP26 climate summit, it seemed that the environmental, social and governance (ESG) movement had finally come of age. Recognizing public concerns over climate change, numerous companies and governments committed to ambitious net zero pledges. In tandem, investors identified the huge potential associated with funding the transition to a low-carbon economy.¹

When the summit took place in November, it was accompanied by the launch of a new global standard-setter for sustainability information, the International Sustainability Standards Board (ISSB). Arguably, the ISSB’s foundation was one of the most significant developments in corporate reporting in decades.

Data shows that ESG is the fastest-growing segment of the asset management industry, with assets in ESG funds growing 53% year-on-year to $2.7 trillion in 2021.²

More recently, however, there has been a shift in perceptions that has left the ESG movement facing some existential questions.

This shift is partly due to the priorities of policymakers and investors evolving in response to new economic and geopolitical challenges (e.g., inflation, the Russian invasion of Ukraine, and growing US-China tensions). It is also the result of growing allegations of greenwashing. Today questions are being asked: What does ESG really mean? Are ESG investors being effectively served by the broader sustainability information ecosystem? Those questions are relevant both to investors that are focused on financial risk and those that are focused on social impact.

One of the issues with ESG as an investment approach is defining exactly what an ESG asset is, especially in today’s complex and fast-changing environment. Also, to what extent can a company be defined as an ESG leader when it performs well on the E criteria, but not so well on the S and the G?

In this critical moment, we examine some of the key dynamics shaping the emerging sustainability information ecosystem and provide our views on how both decision-usefulness and trust in sustainability information can be strengthened.

These recommendations are a starting point in the effort to truly reframe sustainability and they are a reflection that building alliances and forging collaboration is everybody’s business.
I. Introduction

A make-or-break moment

The ESG movement is experiencing historically high stakeholder interest while simultaneously facing difficult questions associated with a lack of standardization, regulation, and common purpose and values. “Greenwashing” in many ways driven by these challenges - has become one of the challenges to its credibility and future success.

There is scant agreement among the many actors - investors, board directors, management, employees, civil society members, ratings providers, auditors, regulators, policymakers - who define the “sustainability information ecosystem” on what ESG includes, how to apply agreed metrics and how best to use available data.

The number of mandatory and voluntary sustainable finance policies and regulations around the world has increased significantly in the past decade and a half. There are now some 870 policies and regulations, with 225 additions or revisions in 2021. Different legal systems and social and political contexts influence the principles on which standards and regulations governing sustainability information are based. To complicate matters further, jurisdictions are moving at different speeds in regulating sustainability information.

Despite these challenges, the prospect for further progress in the sustainability information ecosystem remains strong. Economic, social and political forces are driving the need for decision-useful, trusted and timely sustainability information. For example, a recent EY survey found 9 out of 10 global institutional investors say nonfinancial performance plays a key role in their investment decision-making.

What’s more, three-quarters of the finance leaders surveyed told us they back the need for globally consistent sustainability reporting standards.

There is wide support for a global standard and recognition that a common language of consistent and comparable baseline information is critical in building the architecture for disclosure that can be consistent, comparable and verifiable. However, achieving that global baseline will be difficult. Whereas the financial information ecosystem has matured over a century, the sustainability ecosystem is just over 20 years old and includes a larger and more diverse set of players. Key differences remain and further collaboration and trust-building will be essential to address the ESG movement’s current challenges.

Our report’s objectives

This report aims to:

- Highlight the differences between the financial and sustainability information ecosystems – illustrating the complexities that should be acknowledged and addressed in the latter.
- Articulate the need to deepen stakeholder engagement across the multitude of ecosystem actors.
- Identify key areas of focus to address some of the current challenges faced by stakeholders.

This report is intended to contribute to the dialogue within the sustainability information ecosystem and offer suggestions about how trust and decision-usefulness may be strengthened.

Figure 1 - Rising oil prices have put pressure on the performance of ESG funds

ESG funds had generally outperformed the market during an extended period of low oil prices.

Note: Rebased to 100 at January 1, 2018. | Source: MSCI
II. The evolving sustainability information ecosystem

While there are increasing connections between the financial and the sustainability information ecosystems, there are different voices in the sustainability information ecosystem, including but not limited to largely unregulated ESG ratings and data providers, civil society, including activist investors, and employees.

The sustainability information ecosystem serves two primary sets of user groups.

The first user group consists of those seeking material information related to the financial impact of sustainability-related factors on a company. The second user group consists of those seeking information about the company’s impact on its external surroundings as a result of its activities including on people, communities, the environment and society.

Furthermore, what is included within the scope of “sustainability” remains open to interpretation and expansion, depending on the objectives of the various actors who are part of the sustainability information ecosystem.
The emerging sustainability information ecosystem

For example, what may be immaterial to a company today can become material tomorrow – this issue also underpins the concept of “dynamic materiality.” Therefore, the potential scope of sustainability information demanded by stakeholders both varies and can change given external influences.

These challenges make analysis of information, investment and capital allocation decision-making, and verification and assurance more difficult in the sustainability information ecosystem. At the same time, the lack of a consistent global reporting framework results in disparate company disclosures as well as less reliable data points or inconsistency, and potentially incoherent ESG ratings.

One of the primary paths to achieving sustainability objectives through decision-useful and trusted information is through improving collaboration among the ecosystem actors. Stakeholders often have many shared interests and objectives and mutual dependency. The threat of (real and perceived) greenwashing and misunderstandings about how sustainability data is used underpins the need to engage, which in turn can lead to collaboration and building trust.

There is a generational dimension to understanding shifting trends in stakeholder engagement. Generations Y (a/k/a millennials, born 1981-1996) and Z (born 1997-2012) are increasingly demanding more from the sustainability information ecosystem, and are becoming key stakeholders themselves.

This is not surprising considering both generations have experienced a range of systemic crises, from the 2008 global financial crisis to climate change and the COVID-19 pandemic. While the past generations may have also experienced similar crises, the members of these cohorts are relatively more skeptical of traditional financial services than older generations and have greater expectations of authentic and ethical behavior on the part of the companies they work for, buy from and invest in. Companies will gain these cohorts’ trust by being reliable guardians and providers of quality information that is actionable, robust, derived with appropriate rigor, and independently assured.
In an effort to achieve sustainability information that is decision-useful and trusted, and that will deliver on multifaceted stakeholder demands, we provide the following recommendations we believe the ecosystem needs to act upon:

1. Increase the transparency of composite indicators

There is a need to increase the transparency and understanding of composite ESG ratings. ESG ratings do not serve investors interested in social impact as they are weighted on financial materiality. For those interested in financial risk management, a lack of transparency over the weighting of ESG topics reduces clarity and decision-usefulness.

Each of the four largest ESG ratings providers uses a financial materiality (i.e., financial risk-based) approach in developing ESG ratings. Each has developed bespoke methodologies and algorithms to generate ESG scores and rankings that are often opaque and complex.

The largest providers of ESG data, for example, use dozens of metrics in calculating their composite ESG scores. These issues include everything from climate change to pollution and waste, from product liability to tax transparency.

The weighting of E vs. S vs. G criteria, as well as components within those categories, also vary between ratings providers and may not reflect the understanding or interests of investors. A lack of correlation between ESG ratings providers is well-documented and highlights the consequences of no common standards that are consistently applied. Such widespread disparities reduce trust in the broader sustainability information ecosystem. To increase their usefulness to investors, underlying methodologies and judgments need to be based on transparent and verified sustainability data.

Late last year, the International Organization of Securities Commissions (IOSCO) published a report on this issue, calling for more transparency regarding the methodologies that ESG ratings and data product providers use.

One reason for these disparities is the inability to measure sustainability information comparably across ESG themes. Each component of ESG has its own set of challenges:

- Environmental issues are generally more quantifiable than social and governance topics. However, performance information on environmental factors often remains insufficient for the demands of relevant global stakeholders, who desire more environmental risk data. Some items, such as carbon emissions, can be measured across multiple jurisdictions. But rigorous analysis is challenging due to a lack of consensus on definitions and calculation methodologies (for example, calculating scope 3 emissions often requires using models with high levels of uncertainty built into them).

![Figure 3 - Weighting of climate change-related metrics in composite ESG scores](source: Rhodium Group analysis. Note: Moody’s and Morningstar do not make industry weights publicly available.

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<tr>
<th>Industry</th>
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<tr>
<td>Airlines</td>
<td>29%</td>
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<td>Automobiles</td>
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<td>Banks</td>
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<td>Chemicals</td>
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<td>Coal mining</td>
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<td>Electrical utilities</td>
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<td>Food retail</td>
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<td>Health care</td>
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<td>Hotels</td>
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<tr>
<td>Oil and gas production</td>
<td>8%</td>
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<td>Pharmaceuticals</td>
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<td>Steel</td>
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Recommendations

- Social issues, such as human rights, ethno-racial and gender equity, and labor standards, are even harder to quantify against an agreed benchmark. Local institutional and sociocultural characteristics are difficult to factor into a universal taxonomy. Furthermore, including a “rights-based” approach in the global sustainability information ecosystem will run into the same tensions present within the broader “rights-based” discussion. Different jurisdictions place different priorities on political and civil rights vs. social, economic and cultural rights. Engaging and measuring human rights standards can be value-laden and easily politicized.

- Regarding governance, quantifying the numbers of historically underrepresented groups in upper management and on boards of directors is achievable. Yet, governance also covers some culturally sensitive topics that are difficult to fully capture accurately, for example, labor discrimination. Stakeholders need to be aware of these distinctions, measurement limitations and variations, and recognize that not every E, S or G item can be quantified or that an agreement can be reached as to how each attribute be weighed – and even whether uniformity in weighing can be achieved given the disparity of views of what “good” connotes and across sectors and companies’ size, time horizons and domiciles. The quantification challenge also pertains to the ESG scoring systems, which can as a result lack precision, timeliness and reliability to fully capture a company’s E, S and G practices.

Climate data Q&A

with Trevor Houser, Partner, Rhodium Group

Q: How would you describe the state of climate data? The availability and quality of asset-specific climate data has improved considerably in recent years. Improvement in the resolution of global climate models, combined with the rapid growth in climate-focused econometric research, has made it possible to better understand the impact of changes in the climate on company revenue and operations, real estate investment performance, municipal and sovereign bond risk, etc. A growing number of companies are also measuring and disclosing GHG emissions data.

Q: How helpful are the use of ESG scores to understand climate risk? ESG scores are composite indices reflecting the provider’s view (based on a mix of quantitative and qualitative information) of a company’s performance on a wide range of environmental, social and governance issues, ranging from labor relations to waste management to business activities in countries with authoritarian governments. Given that climate change-related considerations are usually less than 15% of an overall ESG score, they provide relatively little useful information about company-specific climate risk. Other sources of data including individual assessments of various ESG topics (e.g., climate) are likely to generate more meaningful insight.

Q: Do you feel that current climate information is meeting the needs of investors? As the amount of company-specific climate information grows in breadth and complexity, investors are increasingly relying on financial services data providers/rating agencies to aggregate, transform, deliver and interpret those data. The approach taken by those data providers/rating agencies do not always align with investor needs. For example, most ratings agencies focus on climate risk management (e.g., how policies to address climate change could negatively impact a company’s financial performance). But many investors are primarily interested in impact (e.g., how a company’s operations are affecting the climate). While these two objectives – risk and impact – are related, they are not the same. Data providers/rating agencies need to be transparent about assumptions and methods and develop products to meet both risk and impact use cases.
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2. Increase understanding of the varying uses of sustainability information

The two primary uses of sustainability information are to assess (i) financial risk and (ii) social impact. These are not mutually exclusive but are easily confused.

A growing number of institutional investors have turned to sustainability-focused investments and funds on the belief that such funds outperform others without that focus, financially in the long run (owing to better risk management of sustainability-related issues). In a 2019 survey by BNP Paribas, more than half of institutional investors noted improved long-term returns as the main sustainability investment motivation.16

The sustainability information ecosystem has consequently evolved to meet sustainability-related financial risk management. The vast majority of today’s disclosure frameworks and ESG ratings are designed to primarily address this perspective. For example, ESG ratings generally do not gauge a company’s impact on society, but rather measure its relative exposure to various internal and external financial risks as well as opportunities.

Meanwhile, recent growth in sustainability investing has been driven by investors, including millennials, who prioritize social and moral considerations.17 According to a 2021 report, 71% of individual investors, globally, said they want to make a positive social impact as part of their investment objectives; the response rate for millennials was even higher (75%).18

A majority of individual investors, globally, are seeking social impact

Percentage of financial professionals and individual investors, globally, who say they want to have a positive social impact with their investments.

Source: 2021 ESG Investor Insights Report, Natixis

This begs a question: is the current sustainability information ecosystem serving objectives related to both financial and social impact?

While there are overlaps between the main ESG motivations, there remains a need for more clarity on the distinct use cases of sustainability information. Equally, there is an opportunity for stakeholders within the ecosystem, including standard setters and ESG rating agencies, to consider how the needs of all users of sustainability information can best be addressed.
3. | Put in place the conditions to enable assurance

The rise of independent assurance – coupled with enhanced standards and increased automation and reporting rigor – has the potential to further build trust in sustainability information and among ecosystem actors.

In the coming years, market forces will raise the demand for robust, independent external assurance over sustainability information. Mandatory assurance requirements for sustainability disclosure rules are also under consideration in the United States and the EU, which could further increase demand.

Assurance is a key facet in increasing trust in the quality and accuracy of sustainability information. Though building trust is the responsibility of all actors, the role of assurance should not be underestimated. As assurance demand rises, ecosystem actors must recognize the importance of the “three lines of defense” that are critical for building trust and maintaining a rigorous, accurate and unbiased reporting system.

The first line of defense refers to corporate governance including a strong system of internal controls with roles for management, board, audit committee and internal audit. The second line of defense refers to the independent, external auditor. The third line of defense refers to regulatory supervision. Without all three, it will be difficult to both build trust and avoid the pitfalls that come from lackluster information management and controls.

“As the demand for assurance rises, it will be critical that actors in the ecosystem recognize the importance of the ‘three lines of defense’
Q: What role should assurance play in the sustainability information ecosystem?

To instill greater market confidence in sustainability reporting, internal and independent verification should be considered. As regulations are being put in place globally, several have proposed or put in place requirements subjecting sustainability reporting to internal controls and assurance requirements that are similar to those that are in place for financial reporting.

Assurance is an important part of a broader ecosystem – including management teams and board directors that design, implement and oversee internal controls and governance; and supervisory authorities that develop professional standards and ensure robust enforcement, required to build trust and address issues such as greenwashing.

Q: What type of assurance is being provided over sustainability reporting today?

About half of the world’s largest companies have assurance over their sustainability disclosures, though the significant majority are obtaining “limited” rather than “reasonable” assurance on a par with what is provided over financial reporting.

Providers of assurance – including the EY organization – should be subject to robust professional standards including high ethical standards - including independence - quality and external supervision. This is essential to provide stakeholders with a consistent level of assurance quality.

Third, now is the time for all upskilling and capacity building across the ecosystem. One area of untapped potential within companies, is within the finance function. There’s an opportunity to make more strategic use of the finance function to help inject rigor into sustainability reporting and to align financial and nonfinancial reporting. The CFO and finance team can bring value in a range of areas including data controls and processes. We have been upskilling our workforce at EY over the last few years including training our audit teams on new and proposed sustainability standards and launching a new MBA in Sustainability, available to all of our 300,000+ people worldwide. Today, our growing Climate Change and Sustainability Services practice has over 2,300 specialists. and just recently, we.

Finally, and this is related to the last point – we need better data modeling and analytics capabilities that underpin the type of sustainability information that stakeholders are increasingly seeking (e.g., scope 3 and/or scope 4 emissions, human rights supply chain diligence).

Q: What are some of the key actions you would like to see occur as the ecosystem develops?

First, there is a lack of a common language for sustainability reporting – the “alphabet soup” that has long defined the environment is a jumble that satisfies no one. It may have not been appreciated at the time, but the launch of the ISSB at COP26 last year is a significant development that has the potential to drastically change the reporting landscape.

Second, we need new standards - to cover how assurance over sustainability is performed. A growing number of stakeholders are seeking more information than current reporting standards require, including forward-looking information. As sustainability reporting standards evolve a new, globally consistent assurance standard for sustainability reporting is needed to prevent standards fragmentation and consistency which will be expected, and assumed, by users of the reporting.

Providers of assurance – including the EY organization - should be subject to robust professional standards including high ethical standards - including independence - quality and external supervision. This is essential to provide stakeholders with a consistent level of assurance quality.
4. **Develop comparable and interoperable taxonomies**

Sustainability taxonomies (systems designed by jurisdictions for determining which economic activities should be considered sustainable) founded on complementary principles would boost comparability and transparency across markets while recognizing that markets have different philosophies, legal architectures and economic structures.

Taxonomies outline the parameters of what is considered sustainable. Having these in place could help clear up much confusion over what is considered sustainable and what is not. For example, a lack of clarity on which activities and assets can be defined as green has long been identified as a barrier to scaling up green finance.

In its effort to establish international alignment of green taxonomies, the World Bank has published a guide to developing national green taxonomies, aimed at emerging economies seeking to “green” their financial systems to attract investment capital into sustainable economic activities. Some regions or countries are already moving ahead. For example, the EU taxonomy for environmental activities explicitly defines what is considered green and what is not. The European Commission was delegated legal authority to develop a list of environmentally sustainable activities via technical screening criteria for six defined environmental objectives.

The EU is also working with China on a Common Ground Taxonomy in an effort to find commonalities within taxonomies while reflecting different energy transition pathways and political realities.

While not as advanced as green taxonomies, developments regarding transition and social taxonomies are also ongoing in various jurisdictions. All taxonomies should have a clear, data-driven reason for why a particular activity falls in or outside of that taxonomy’s definition of sustainability.

5. **Lower barriers for market participants in emerging economies**

**Bringing emerging markets into the sustainability investment ecosystem through removing or lowering the barriers, so that they can benefit from private capital seeking sustainable investments, is critical.**

Emerging economies will account for a large majority of the world’s greenhouse gas emissions by 2050. Yet, they have less resilience to be able to adapt to the impacts of climate change and are located in the areas most likely to be severely affected by climate-related events. Attracting capital to activities that do not just slow climate change but mitigate its consequences is essential.

The UN Conference of the Parties (COP) process is notable for recognizing the need for significant financial transfers from the largest economies to developing markets, if the goals of the Paris Agreement on Climate Change are to be met. While mechanisms like the Global Climate Fund for those financial flows to occur have been created, the funds are not moving as promised.

The absence of comprehensive sustainability data in emerging economies suggests a need to lower barriers for market participants in these economies to disclose sustainability information. This is not to advocate different standards, which could be counterproductive, but rather to suggest that there should be more upskilling of technical assistance and engagement with emerging economies in the sustainability information ecosystem.

Emerging market governments can benefit from the international standard setting work done by the International Sustainability Standards Board (ISSB) by adopting its standards into their legal frameworks. Emerging markets will also benefit from the continued focus on promoting additional rigor and transparency in the carbon offsets market which can be a way to further foster investment in emerging markets who have natural absorption capacity.
The increasing maturation of the sustainability information ecosystem has been nothing short of extraordinary. Current challenges facing the ESG investing movement — and its multitude of actors, each with varying degrees of influence and intention — are a product of its infancy.

In the months ahead, the ISSB will finalize its initial sustainability disclosure standards while — at the same time — policymakers and regulators are poised to take further steps that mandate sustainability disclosure in most of the world’s largest economies. At the same time, other core elements of sustainability information — notably ESG ratings — are expected to face heightened regulator interest and action.

Amid these policy developments, the broader ecosystem will continue to debate the ideal relative roles that actors in the ecosystem play, lessons that can be learned from the financial reporting ecosystem, the continued broadening of the definition of ESG, and how the ecosystem serves investors and other stakeholders focused on financial risk and social impact.

These are important questions, and this is a constructive new phase for the sustainability information ecosystem and ESG investing. More work must be done to encourage open collaboration and trust-building. The recommendations in this report are not a panacea for addressing the difficult questions facing the ecosystem but they are important areas of focus in the move toward information that is decision-useful, timely and trusted.

Conclusion

The views of third parties set out in this publication are not necessarily the views of the global EY organization or its member firms. Moreover, they should be seen in the context of the time they were made.
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We would also like to thank Trevor Houser and Katherine Martin for their contributions.

2. Money held in sustainable mutual funds and ESG-focused exchange-traded funds rose globally by 53% last year to $2.7 trillion, with a net $596 billion flowing into the strategy, according to Morningstar Inc.

3. The risk that investors and other stakeholders could be consciously or unconsciously misled about the sustainable characteristics of an entity, financial product or service.

4. Throughout this report we use “sustainability information” to refer to corporate reporting and disclosures; sustainable finance taxonomies; ESG ratings; and underlying science, data and modeling capabilities. Many people see sustainability information as more limited to environmental and natural resource-related issues. We use a broader definition here but recognize that this is an important unsettled definitional issue.

5. According to PRI, sustainable finance policies and regulations include those that: a) support national policy goals on climate change and the SDGs; b) enhance the resilience and stability of the financial system and the economy; c) improve market efficiency by clarifying and aligning investor and company expectations; and d) increase the attractiveness of countries as investment destinations.

6. Regulation Database, PRI, accessed on July 3.

7. Fifth global institutional investor survey, EY Climate Change and Sustainability Services (CCaSS), July 2020 (page 23).


12. One key development towards more effective ESG metrics and a mechanism for comparative reporting is the creation of the private equity industry’s ESG Data Convergence Project. In under one year of its existence, it has amassed 1,400 private companies (representing USD 8.7 trillion in assets under management) to commit to a collaborative ESG reporting system.

13. IOSCO calls for oversight of ESG Ratings and Data Product Providers

14. According to Berg et al. (page 4) measurement variations is the main driver of rating divergence, contributing 56% of the divergence. Scope divergence is likewise important, contributing 38%, while weight divergence contributes 6%.

15. See for example, One year on from commitments on adaptation: Lack of risk data and standards delaying progress, UNEPFI, February 14, 2022.


19. Preventing and detecting fraud: how to strengthen the roles of companies, auditors and regulators, EY, November 2020 (page 5).


22. The Science-Based Targets initiative (SBTi) net-zero standard is expected to serve as a global certification standard for corporate net-zero carbon targets. SBTi offers a robust approach to using climate science for defining and promoting best practices in a company’s emissions target-setting process. The SBTi offers sustainability stakeholders the following assurances. First, companies must follow strict SBTi guidance when developing their goals. The purpose is to make it easier to evaluate the strength of the company’s targets. Second, SBTi reviews and approves all company submissions, which drives consistency and transparency. Carbon offsets and avoided emissions are not allowed. And Activist Investors and a ‘Greenwashing’ Backlash: Change is Coming to the Corporate World, CNBC, January 25, 2022.
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