FINANCE

TREND
TRANSPARENCY

As it surges ahead, the ESG market seeks to standardise transparency norms

Financial institutions increasingly focus on their environmental, social and governance (ESG) impact, and markets are commensurately eager for transparency regarding the extra-financial performance of assets and companies. However, a diversity of data providers, the absence of international reporting standards and broadly shared metrics have all contributed to the rise of a market lacking in consistency and direction. In order to effectively guide participants and standardise disclosure practices, new regulations are emerging, and international initiatives are attempting to bring order to the landscape.

DATA OVERVIEW

Extra-financial transparency remains elusive as ESG investments explode

Environmental, social and governance (ESG) investing is growing at a high speed. In 2021, a record $649 billion was invested in specialist ESG funds, up 19.7% from 2020 ($542 bn) and 127.7% from 2019 ($285 bn). ESG funds now account for 10% of global assets under management, according to data from Refinitiv.[1] Per Bloomberg, the total value of ESG assets under management could exceed $41 trillion in 2022, and $50 trillion by 2025.[2]

These figures illustrate investors' growing interest in financial products that address extra-financial objectives. While foremost driver of this trend is a desire to manage the risks associated with financial institutions' portfolios, monitoring the impact of investments on the environment and society is another. To achieve this, financial institutions must rely on the ESG performance data companies disclose.

However, surveys conducted among financial actors show that not all topics receive the same attention. According to the CDP's annual questionnaire, for instance, a greater proportion of the 377 financial institutions consulted assess their portfolio's exposure to climate-related risks and opportunities (86%) than to water (67%) or forests (55%).[3] The law firm White & Case, which analysed the reports and proxy statements of 50 Fortune 100 companies listed with the Security and Exchange Commission (SEC), notes that all the companies examined now make ESG disclosures relating to the environment. Climate-related disclosures in particular are quickly becoming more common.[4]

Furthermore, within any particular sector, company performance in terms of ESG engagement and transparency may vary widely. For example, according to the Forest 500, which analyses the commitments of world-leading commodity companies exposed to deforestation risk, 58% of the 500 companies and financial institutions involved in forest-risk supply chains have made commitments on the issue of deforestation, compared to 57% in 2020, and 52% in 2019. The level of commitment varies, from an average of just 28% in the leather sector and 30% in the livestock sector, to 72% in the palm oil business. But most of the companies making commitments struggle to provide evidence on progress towards their targets. Furthermore, 93 of the 150 financial institutions deemed most exposed to deforestation have no commitment to combating deforestation in place, while providing $2.6 trillion in financing to companies carrying the highest deforestation risk.[5]

Such disparities, which are not unique to environmental objectives, reveal a wide range of standards and methods for assessing ESG performance. Market dynamics highlight the importance of rigorously defining ESG criteria to ensure that assets are aligned with climate and sustainability objectives.

THE OBSERVATORY'S LENS

A scattered standardisation of ESG practices is underway

The TCFD and UNEP FI, two international frameworks for promoting the collection and communication of ESG information and company performance

Beyond the adoption of regulations by authorities to better identify and qualify investments with a positive impact on the environment and society (**see 'Supervision' trend**), initiatives are emerging with a view to improving transparency and communication by stakeholders through the disclosure of companies' extra-financial performance.

France, for example, has long been at the vanguard, introducing its New Economic Regulations (*Nouvelles Régulations Econonmiques)* legislation, known as the 'NRE law' (2001),[6] followed by the Grenelle I law (2009)[7] and Grenelle II (2010),[8] which have not only made it possible to establish environmental objectives and sectoral roadmaps, but to embrace an ecological governance, aimed *'primarily [at] expanding the right to environmental information by prompting public entities and companies to disclose the ways in which they take into account the imperatives of sustainable development in their strategies'.*

This makes access to extra-financial information a critical component of managing and monitoring the shift towards a less carbon-intensive economic model, both on the part of companies themselves and of the financial sector, which must finance the economy's transition. Reliable databases are a prerequisite to the useful exercise of such a right to information. Consequently, the French and European authorities have acknowledged the growing urgency of imposing clear rules to ensure solid extra-financial reporting based on robust indicators that are easy to access for investors and the other stakeholders.

Furthermore, transparent and consistent extra-financial reporting makes sustainable investment decisions easier for private and public investors. And last but not least, it permits closer scrutiny of corporate activities and governance, with the option of rewarding the most virtuous companies aligned with various climate and societal objectives. Indeed, the frequency with which scandals have emerged in recent years has prompted regulators to exercise greater oversight and companies to protect themselves from reputational risk.

These reinforcements on verification and oversight highlight a peculiarity of the ESG field, namely that the definitions of eligible activities or investments are currently imprecise, which increases the risk of variably demanding interpretations by economic and financial actors, increasing risks of investor confusion and greenwashing. This is why creating a reference framework for the disclosure of extra-financial performance to ensure the best possible access to transparent, accurate and standardised data has become a major priority.

To meet regulatory requirements and societal expectations effectively, companies need frameworks for communicating their extra-financial performance. These frameworks must offer levels of standardisation sufficient to permit maximum utility and comparability of ESG information. In view to meeting this need, various private and public bodies have started to propose criteria and reporting models adapted to different sectors.

Consequently, with the rise of ESG investing, fund managers need ESG data, tools and analytics to facilitate decision-making and steer their portfolios towards commitments that are quantifiable and measurable. ESG data plays a central role in meeting the information needs of stakeholders and investors on topics including risk management, contributions to the Sustainable Development Goals (SDGs) and environmental and social objectives.

Since 2017, the Task Force on Climate-related Financial Disclosures (TCFD), an initiative of the G20's Financial Stability Board (FSB), has been proposing a series of recommendations on how to communicate transparently on financial risks related to climate issues. The guidelines are also designed to help investors, lenders and insurers take decisions on capital allocation. The TCFD is structured around four themes critical to business operations: governance, strategy, risk management, and performance indicators & targets. To date, the TCFD's recommendations are not binding and rely on companies' willingness to participate. However, the UK has set a target of making compliance with TCFD recommendations mandatory by 2025 for companies in most sectors, which opens the way for future regulatory positioning of the TCFD.[9] Other countries, such as Australia, Canada, Italy, South Africa and Turkey are in the process of consulting with the private sector to make the reporting framework compulsory.

Adopting a similar focus on consistency and comparability in ESG reporting, the United Nations Environment Programme Finance Initiative (UNEP FI) has developed a reference framework to ensure the strategic alignment of banks with the Sustainable Development Goals (SDGs) and the Paris Agreement. The *Principles for Responsible Banking* (PRB) enable signatory banks to ensure that their business makes a positive contribution to society. The principles are divided into six main categories:

- Aligning business strategy to be consistent with people's needs and to contribute to societal goals
- Defining targets and positive impacts
- Including customers and consumers to promote sustainable practices
- Consulting and engaging with relevant stakeholders to achieve societal objectives
- Establishing effective governance and a responsible banking culture
- Attentively monitoring individual and collective implementation of the principles to ensure transparency and accountability for both positive and negative impacts

To this effect, PRB signatory banks are required to periodically show how they are meeting social expectations through structured reporting and standardised disclosure of extra-financial performance indicators and targets. Today, more than 270 banks, representing over 45% of the world's banking assets, have joined the UN initiative. A similar framework has been proposed by UNEP FI for the insurance sector with the *Principles for Sustainable Insurance* (PSI).

Rating agencies are driving a growing ESG data market

Access to extra-financial information can considerably affect investment choices according to a '*best in class*' approach,[10] which involves the construction of a portfolio favouring issuers that exhibit the best ESG practices in their sector of activity. This approach is gradually gaining traction in the financial sector thanks to ESG labels (e.g., the SRI Label, Greenfin, etc.). Another factor is the influence of rating agencies, which rely on the extra-financial reporting of companies in designing their evaluation criteria.[11,12]

While the various ESG compliance and disclosure initiatives are a direct response to the needs of investors and public bodies, extra-financial data is now also essential for companies, to limit the risks associated with their activities. It is crucial to have reliable performance indicators to prevent and anticipate financial losses (e.g., stranded assets) over varying time horizons. Today, climate risks are classified into two main categories: physical risks (direct results on a company's business due to the effects of climate change) and transition risks (financial impact related to the restructuring involved in shifting to an economic model that emits less GHG). As this is a key issue for both financial players and companies themselves, integrating extra-financial data into risk measurement has become a critical focus.

Optimal assessment of extra-financial risks calls for standardised and transparent frameworks. According to the Woodwell Climate Research Center,[13] the lack of transparency in risk measurement makes it impossible to guarantee the scientific validity of information provided to investors and regulators. Indeed, the wide variance in methodological choices regarding risk measurement can easily lead to forecasting errors. One solution for dealing with disparities is to establish standards that specify the choice of risk model, the selection of appropriate time horizons and the choice of scenarios for the various environmental factors.

Ratings agencies appeared at the beginning of the twentieth century, following the 1907 banking crisis in the United States, which exposed the need for independent and relevant indicators to rate and evaluate the profitability and financial soundness of companies. Moody's was the first player on the market to provide ratings on demand, followed by Poor's, the Standard Statistics Company and Fitch Publishing.

Well into the 1970s, many players entered the rating market without any specific control or regulatory obligation. The first oil crisis in 1975 and subsequent crises (Enron scandal, 2008 financial crisis, etc.) confirmed a need to regulate these independent agencies. It was at this time that ESG ratings based on extra-financial data began to appear at specialised agencies, before developing exponentially in the early 2000s.

This nascent and—at the time—poorly regulated activity yielded a multiplicity of players specialising in the collection and provision of ESG data and indicators. This exacerbated the heterogeneity and dubious transparency of the underlying methodologies as well as the design of indicators. Today, the ratings agency market is becoming increasingly concentrated due to various takeovers of European agencies specialising in extra-financial information by the 'Big Three', Moody's, Standard & Poor's and Fitch, which account for over 90% of the financial ratings market. In 2019 alone, Moody's acquired Vigeo Eiris and Four Twenty Seven, while Standard & Poor's acquired TruCost in 2016, RobecoSAM in 2019 and recently merged with IHS Markit in 2020. Other data providers, such as MSCI, ISS ESG, Sustainalytics or even the London Stock Exchange Group have come to represent a considerable part of the ESG data market. This consolidation of the market should lead to more reliable ESG data on the one hand, and to easier access to said data on the other. In addition, other, more specialised players, such as CDP, Ecovadis and Ethos remain alive and well, providing more specific and targeted services in the realm of ESG ratings. CDP, for example, offers to make climate data reported by companies and cities public and accessible on its platform. Ecovadis, on the other hand, offers a range of comprehensive solutions for managing the ESG risks and performance of supply chains. Many companies are now offering innovative services designed to rate, assess and manage extra-financial data, each with its own approach to handling ESG information.

Weaknesses of ESG data in terms of transparency, reliability and standardisation

Disparities in methodological and thematic choices

The problems encountered by investors in attempting to collect, process and disclose ESG data are multiple. Notable current challenges in ESG reporting include companies' unreliable self-assessments of ESG performance due to increased greenwashing, a lack of transparency in methodologies used to calculate indicators, and the absence of standards that would enable data comparison.

In March 2022, asset manager State Street Global Advisors (SSGA)[14] published an article on the challenges facing ESG data and the importance of data quality in responsible investing. The text presents several examples of ESG rating cases and data from reputable ratings providers. These providers are essential when it comes to collecting, evaluating and rating companies on their ESG characteristics.

SSGA observes that when a stakeholder selects a single provider from the field, not only will they have a biased viewpoint due to alignment with that provider's ESG investment philosophy, but they will make decisions based on this viewpoint without a thorough understanding of how the data or information was obtained, since the methodology used by a data provider is often proprietary.

The article identifies several areas of divergence. First, procurement techniques and data estimation models can vary considerably. Second, providers may have differing biases regarding materiality in relation to the same company. Third and last, ESG data providers have their own methods for aggregating and weighting certain ESG factors, and these are not disclosed to stakeholders or investors. Similarly, a 2022 OECD publication[15] on ESG ratings compares four providers, illustrating how the scores provided by these players vary considerably in their calculations given that they are based on different types of data and do not share weighting or extrapolation methodologies.

These heterogeneities in ESG orientations are not only found among providers. Comparing databases for US and European companies, Intercontinental Exchange,[16] a provider of ESG data, found considerable differences in company reporting practices between these two geographical areas. Indeed, these reports vary globally in terms of the indicators disclosed, the areas covered, and the societal objectives targeted. For example, European companies tend to report more on their commitment to the SDGs, and are more comprehensive and rigorous when reporting on climate, circular economy and social inclusion issues. The European market is commensurately more mature than its US counterpart in terms of ESG reporting and setting extra-financial targets.

In addition to differences in maturity that may currently exist between the United States and the European Union, there are also considerable differences in the approaches adopted by regulators in each geography as regards ESG issues. On the one hand, the European Union has favoured centralising its extra-financial objectives via the regulations mentioned above, enabling a common framework of actions and measures set at different time horizons. Conversely, the United States has opted for a less regulatory vision privileging voluntary ESG

FIGURE 1

MAPPING OF MAJOR RATINGS AGENCIES AND ESG DATA PROVIDERS

Source: AMF, 2020

LARGE FINANCIAL ACTORS	ACQUISITIONS OF HISTORICAL ESG PLAYERS	MAIN SOLUTIONS/SERVICES (O/W RATINGS & INDEXES)	+ OTHER KEY INDEPENDENT ACTORS	
MSCI	Innovest (2009) RiskMetrics (2010) GMI (2014) Carbon Delta (2019)	ESG Ratings (AAA to CCC) MSCI ESG Indexes & Bloomberg MSCI ESG Indexes	CDP	Climate, Water, Forest data, ratings and rankings
MOODY'S	Vigeo Eiris (2019) Four Twenty W (2019)	ESG Scores & Assessments ESG Indexes with Euronext (eg. ESG CACA40, Eurozone 80…) and Solactive	FactSet Ecovadis	ESG ratings & services for investors Sustainability Assessment
S&P GLOBAL	TruCost (2016) RobecoSAM (2019) HIS Markit (merger, 2020)	EST Evaluation & ESG Score (Corporate Sustainability Assessment) DoW Jones Sustainability Indexes (DJSI) S&P ESG Indexes	Arabesque Inrate	ESG Data & Scores : S-Ray & ESG Book ESG Impact Ratings
ISS ESG (DEUTSCHE BÖRSE, 2020)	Ethix SRI Advisors (2015) SouthPole (2017) Oekom (2018)	ESG Corporate Rating, Governance Quality Score, ESG Scorecard, E1S Disclosure Qualityscore… ISS ESG EVA Leaders Index Series	Rep Risk	ESG Risk Platform
SUSTAINALYTICS (MORNINGSTAR, 2020)	Jantzi (2009) ESG Analytics (2015) Solaron (2018) GES (2019)	ESG Risk Rating (grade from 0 to 50+, the lowest is the best)	Ethos Owl Analytics	ESG Rankings & ratings by cause ESG Data, Scores & rankings
LSEG (LONDON STOCK EXCHANGE GROUP)	FTSE Russel Refinitiv – Thomson Reuters (2019) Beyond Rating (2019)	Refinitiv « Company Data » (including ESG) FTSE4Good Invest, FTSE ESG, Climate… Russel ESG Indexes	Covalence Impak	ESG Ratings & Data Impact Assessment, Rating and Tracking for Investors
BLOOMBERG		Bloomberg's Environment, Social & Governance (ESG Data)	EthiFinance	ESG Assessment and European SMEs
SUSTAINABLE FITCH		ESG Ratings, ESG Relevance Scores, Climate Vulnerability	CSR Hub Ideal Ratings	Consensus ESG Ratings ESG Ratings & Scores

disclosure mechanisms. An article by the Brookings Institution, a think tank, entitled "The risks of EU-US divergence on corporate sustainability disclosure," argues that such divergences offer asset managers an opportunity to pick and choose the definition of ESG criteria themselves.[17]

Financial actors in need of public support and available corporate data

It is clear that without support from public authorities, it is complicated for data providers and financial and extra-financial actors to make choices that will meet societal expectations.

An article published by the consultancy I Care and Consult[18] addresses the extra-financial transparency requirements facing European financial institutions under the European Commission's Sustainable Finance Action Plan (notably *Sustainability-Related Financial Disclosure EU 2019/2088* - SFDR) and Article 29 of the French Energy-Climate Law, (**see 'Regulations' trend**).[19] The authors highlight the importance of identifying and developing robust indicators to meet new transparency requirements, but also note the difficulties for financial entities of navigating the selection of ESG indicators from various 'sub-domains'.

Climate-specific indicators are increasingly prevalent in extra-financial reports. However, stakeholders are left with a vast array of indicators, whose values vary according to methodological choices (e.g., types of allocations and alignment). Furthermore, results may arise from the range of emissions studied by the entities and whether or not they choose to include Scope 3. This makes it difficult to compare indicators between companies and sectors.

In addition, financial companies must now develop indicators to measure biodiversity footprints. Here again, stakeholders must navigate a host of standards and methodologies as far apart as the Corporate Biodiversity Footprint and the Global Biodiversity Score[20] which adopt different approaches over time. Meanwhile, other recommendations are taking shape, such as the Biodiversity Footprint Financial Institutions (BFFI) tool[21] and the Taskforce on Nature-related Financial Disclosure (TNFD).

However, identifying and selecting indicators constitutes only one aspect of the challenge for investors. The major difficulty lies in the availability of company data, and access to the information required to perform ESG analysis, which varies greatly depending on the investment type and the influence of the financial institution. The industry, origin and size of the company also have a significant impact on data availability. For instance, a small or medium-sized, company, with small support and guidance from regulation, will face difficulties to collect hardly accessible data on a voluntary basis.

The accessibility of ESG data in Europe is set to increase with advent of a Corporate Sustainability Reporting Directive (CSRD).[22] For context, on 21 April 2021, the European Commission (EC) adopted a proposal for a Directive on Corporate Sustainability Reporting (CSRD) to address current difficulties in the collection and use of extra-financial data. Amongst other changes, the proposal extends to all companies with more than 250 employees the obligation to collect extra-financial information, requires audits of the information provided and introduces more detailed reporting requirements. However, the main contribution of this European Commission proposal consists in endorsing European Sustainability Reporting Standards (ESRS),[23] which serve to standardise the reporting methods of European companies.

These actions should make ESG data easier for investors to access. Also to this end, the European Commission has announced the creation of a European-wide database providing a single portal for regulated information to centralise all disclosures by European listed companies: the European Single Access Point (ESAP). This is relevant, as a lack of internal financial and technical resources to collect and process the data available to financial actors can lead to a dispersion of the data and information available to investors.

The battle between EFRAG and ISSB over ESG reporting standards

The Global Reporting Initiative (GRI), close to the European vision, has long provided industry standards to ensure best practices in the realm of extra-financial performance disclosure. The GRI has articulated 10 principles for ESG data to ensure high quality sustainability reporting. Four principles relate to content: stakeholder inclusion, sustainability context, materiality, completeness. The remaining six pertain to quality: accuracy, balance, clarity, comparability, reliability, timeliness.

To address the difficulties encountered in obtaining data from companies, various entities are developing extra-financial reporting standards. The IFRS Foundation has set up an International Sustainability Standard Board (ISSB) which aims to propose sustainability standards that will be understandable, applicable and accepted worldwide. It differs from the European project in that it focuses solely on the financial materiality of ESG risks, whereas Europe will also impose reporting on companies' ESG impact, per the principle known as 'double materiality'.

It goes without saying that such parallel standardisation work risks promoting the development of two divergent approaches, defeating their purpose and further confusing companies' ESG reporting practices.

The absence of a 'universal standard' for ESG data presents several obstacles to achieving credible results in both the short and long term. Worldfavor,[24] a consultancy, has compiled a series of implications to justify the need to align ESG and other extra-financial reporting requirements under a consistent framework. Among other effects, they point out that the proliferation of standards, frameworks and initiatives is forcing companies to each come up with the resources needed to design their own models for disclosures. A single standard for extra-financial information would help companies know what's expected of them in terms of reporting content and how to communicate this information to stakeholders. According to Worldfavor, having a single ESG management system would ensure key stakeholders secured full control over what is measured and how.

Bearing witness to the difficulties companies face in ESG reporting, Schneider Electric published an article in April this year, entitled 'Trends & challenges with standardising Corporate ESG disclosures'. In it, competing standards for ESG disclosure are presented as misleading and time-consuming for ESG reporting. Companies lack clarity on the norms to adhere when reporting, which severely limits stakeholders' ability to assess and compare ESG performance and risks.

The main source of complexity in creating a universal ESG reporting mechanism comes from questions around the feasibility of extra-financial reporting and whether it should be compulsory or voluntary. In September 2020, five major global reporting organisations joined forces to form the Comprehensive Reporting Group, with the intention of providing a common framework with a single set of global reporting standards. This could also allow ESG data providers to have a single frame of reference for the information collection and processing phases. The group brings together frameworks that reference the GHG Protocol, Global Reporting Initiative (GRI), CDP, Climate Disclosure Standards Board (CDSB), International Integrated Reporting Council (IIRC) and Sustainability Accounting Standards Board (SASB).

KEY TAKEAWAYS

Janine Guillot, Executive Director of the Sustainability Accounting Standards Board (SASB),[25] sees the transparency of ESG practices as a 'collective effort to be taken up by all market players,' including asset owners, asset managers, data providers, standards and policy makers. Granted, bringing these parties together is a challenge in own right, however, this merely underscores how coordinated work by all stakeholders, public and private, is critical to addressing the many issues we currently face. Measuring the footprint of financial players' actions in a structured manner should make it possible to identify the best levers for action to reduce this footprint. This effort involves standardising calculation methodologies, strengthening databases and reinforcing the reliability of reporting systems.

Following the European Commission's public consultation on ESG ratings, the Autorité des marches financiers (AMF) has called for the establishment of a European regulatory framework for ESG data, ratings and services providers.[26]

FINANCE

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