EUROPEAN CAPITAL MARKETS INSTITUTE

Europe's CSRD is an opportunity, not a chain around its neck

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The Corporate Sustainability Reporting Directive (CSRD) is often mentioned as one of the examples of the European Commission's excessive zeal when working to implement the Green Deal. It's given as an example of overregulation that negatively impacts the competitiveness of European corporations, creates access barriers to the EU market and is very costly to implement.

However, the CSRD is not seen as a potential opportunity for Europe's capital markets, offering the possibility to get ahead of others in sustainability disclosure. Through the 'double materiality' approach it introduces with structured reporting, it sets a strong EU standard, when we don't even have a comparable European accounting standard.

Disclosure is central to the well-functioning of capital markets. Following former US Supreme Court Judge Brandeis' dictum that 'sunlight is the best disinfectant', CSRD expands the obligation to disclose to sustainability reporting – and not only to listed corporations but also to some 50 000 companies. As such, much more information will become available to the public, acting as a disciplining factor but also facilitating the scaling-up of these companies, thus far a structural weak point in Europe's capital markets. The CSRD replaces the 2014 Non-Financial Reporting Directive and reporting will apply from 2025 onwards for large companies and from 2026 for mid-sized companies.

Green and financial disclosure are seen as two different disciplines and are too often dissociated from each other, including in the regulatory debates. They are intrinsically linked, however, as investors price in all information available to make an accurate assessment of a company's prospects and this includes non-financial information.

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The original version of this article was published by IPE in October 2024.

That's why making CSRD obligatory for a larger percentage of companies is beneficial – it allows them to better prepare for the market's (sometimes ruthless) discipline and for growth. In the US, climate-related disclosure only applies to listed corporations, governed by US securities law under the Securities and Exchange Commission's control. But listed corporations are nonetheless declining in the Western world.

The CSRD faces criticism due to its large costs. Based on an analysis of the two initial standards, CEPS estimated a one-off cost of EUR 287k for reporting and about EUR 320k on an annual basis for listed corporations (2022 data). For smaller companies, the costs are EUR 36k for a one-off and EUR 40k recurringly. Another critique is the very detailed nature of the taxonomy that defines what is sustainable.

The opportunities stemming from CSRD are much less highlighted. Overall, we see 10 advantages:

1. There will be one management report, including financial and non-financial disclosure, bringing all the relevant company information together into one place;

2. It will allow for a much more comprehensive overview of a given company, well beyond its balance sheet and profit and loss statement;

3. The sustainability disclosures are standardised and widely applicable, of which work is still ongoing. An initial set of 12 standards (European Sustainability Reporting Standards, ESRS) have been developed, consisting of two general standards and 10 that are topic specific. Compare this to company accounting, which isn't yet standardised in the EU27 or EEA30 (except for listed corporations). All information will be digitally available and xBRL-tagged, which facilitates readability and consolidation;

4. This should allow for high-end sustainability disclosure and more transparency, thus making disclosures trustworthy;

5. The information is – following the double materiality approach – subdivided into financial and impact materiality, which makes it easier to grasp. Companies need to disclose the data points that are relevant to them;

6. There is a clear timeline clearly showing when everything must be ready. As often is the case in EU integration, timelines have helped to create a positive dynamic.

7. A single EU standard is a big boost for the single market in sustainability reporting and beyond. It will stimulate the development of single data sets, allowing for the comparability of sustainability targets;

8. In the CMU's perspective, it allows well-prepared and sustainable companies to scale up, to tap external sources of financing, including venture capital and private equity investors, and the regulated markets in the member states;

9. The CRSD's structure allows for better internal controls, including oversight from a company's board, and for external auditors. It allows for accountability and better reporting

for what were distinct and separate chunks of information. Auditors will be required to provide limited assurance (stating that they are not aware that the information is materially misstated) on a company's reported sustainability information, then moving to reasonable assurance over time (when the information reported is materially correct). All this will make supply chains more visible to interested parties.

10. As such, it's an educational experience, setting ambition and providing new opportunities over time for European companies.

There's no going back in the world's quest to roll back carbon emissions and fulfil the goals set by the Paris Climate Agreement. The CSRD is part of the EU's drive to make sure that it does everything it can to achieve these goals. It also has the benefit of preparing European companies for tougher oversight, making them more competitive. Other countries are taking different approach to reach the same goal, adopting the international standards set by the ISSB. Work is ongoing to ensure full interoperability between the CSRD's ESRS and those set by the ISSB.

It is also an illusion to believe that green 'deregulation' could happen. These rules have been adopted as the result of a long and laborious process. Making changes would raise the question what has to be changed, and to what degree. It will be opening a Pandora's box and re-open the decision process. It will delay timely implementation, which already is a problem. Moreover, it will give the impression that the rules are somewhat arbitrary, and that they can be changed easily. It should be reminded that President von der Leyen has stated in the inaugural European parliament speech of her second term on 18 July 2024 that Europe will stick to the Green Deal, a commitment to have the backing of the Greens.

Comparable, consistent and reliable sustainability disclosures can incentivise the flow of green funds into the European capital market, especially to those companies who perform well sustainability-wise. In this way the CSRD can enable a competitive advantage for European firms – rather than disadvantage them – compared to US or Asian markets.

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