Implementing ISSB Standards across the IFCs

**Tranposing accounting standards
to a regulatory framework
(or from TCFD to ISSB and back again)
A discussion paper.**

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Summary.

Our 2023 survey of the state of sustainable finance across the international finance centres (IFCs) in collaboration with the Group of International Finance Centre Supervisors (GIFCs) revealed a near-unanimous commitment by financial supervisors to the adoption of global sustainable finance rules. This commitment driven by the International Sustainable Standards Board's (ISSB) global standards established in 2023, which gained rapid endorsement by IOSCO calling on its members to transpose the standards into national regulations.

When creating TCFD (the Task Force on Climate Change Disclosures) guidance, the forerunner of these standards, in 2017, the Financial Stability Board (FSB) deemed climate to be a potential financial stability issue. From here the regulatory mandate for a requirement for firms to assess and disclose their exposure to climate risk flows.

ISSB's S1 standard establishes global requirements for sustainability-related financial disclosures, focusing on the impact of sustainability issues on an entity's performance, position, and cash flows. The S2 standard focuses on the impact on financial performance of the specific climate risk, following the rationale of the regulatory framework TCFD with many similar elements. There is a real question mark over the mandate for financial service supervisors to require firms to assess and disclose their exposure to generic sustainability risks. In practice global rollout of the ISSB standards is likely to be restricted to the climate rules.

In our survey, many supervisors expressed concerns about ensuring regulatory coherence when ISSB standards are transposed into national regulations. There is already evidence of regulatory divergence between the EU, the UK and the USA in the manner of implementation of sustainable finance regulations.

Moreover, the ISSB standards are, in fact, accounting standards. IOSCO may have welcomed these standards and called on their members to speedily adopt them, but they have been silent to date on exactly how. Transposing global accounting standards into regulatory rules is not a straightforward exercise but one that requires consideration and deliberation of many factors.

Given the starting point was the TCFD, a regulatory framework, some might query if we have not traveled a long and circuitous route. However, given the public endorsement by the FSB and IOSCO and the commitment expressed by the supervisory bodies of the IFCs, forward movement can be presumed across the IFCs.

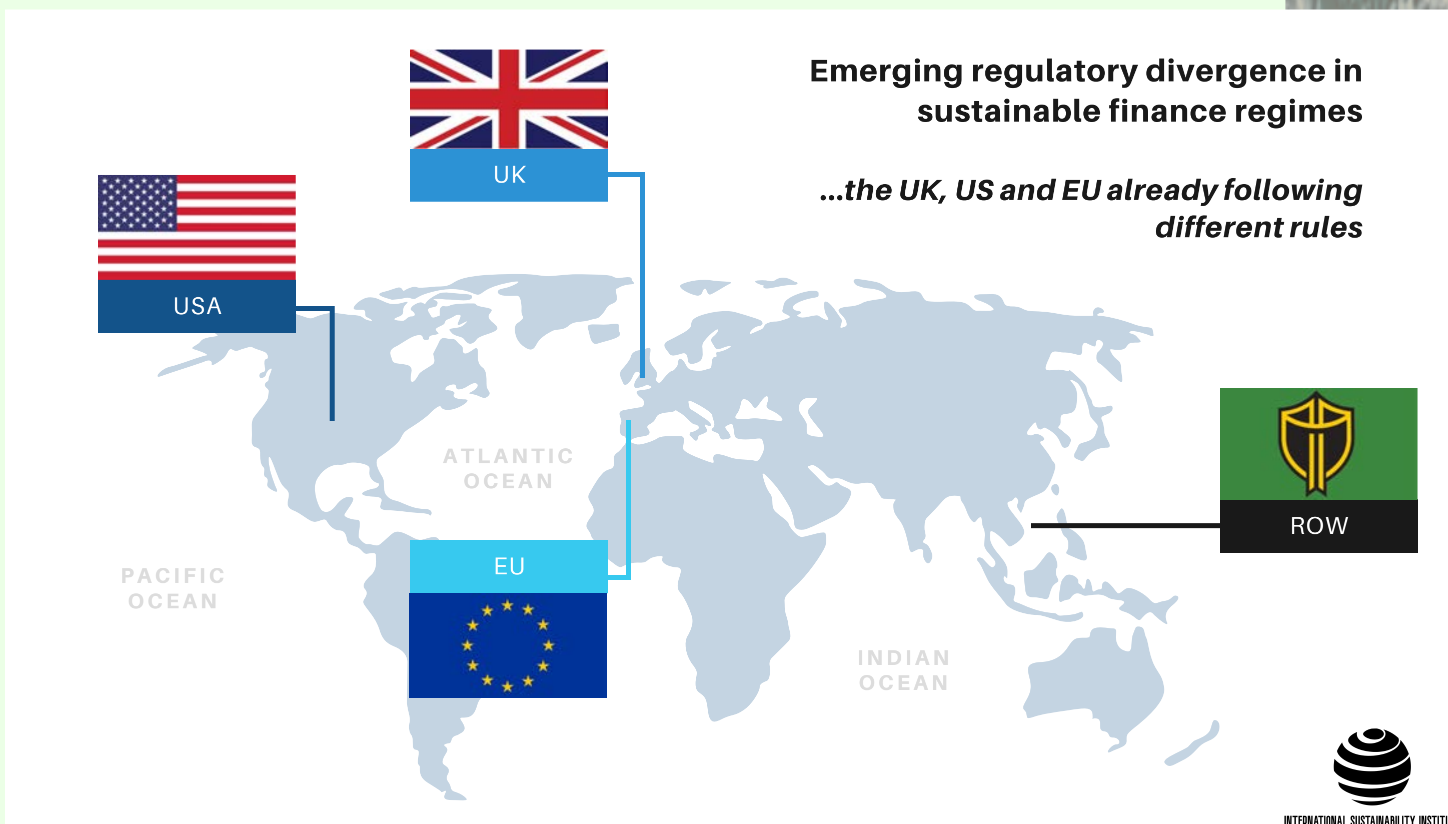
The path already trodden by the UK and EU provides some guidance on implementing climate rules. But the biggest issue for IFCs is the regulated fiduciary sectors where there is no example to follow, it being a sector seldom incorporated into mainstream global supervisory rules. Given the scale and significance of this sector for many IFCs, not least the Channel Islands where the assets administered by the fiduciary sector combine to several billions across the two jurisdictions (and amount to many multiples the size of their funds sectors), omission or effective omission of this sector from scope of any regulations would seriously undermine the legitimacy of their sustainable finance regulatory regimes and call into question the integrity of the offshore sector, harming the sector's reputation. We therefore look at how this might be done.

Background.

Seven years have elapsed since the TCFD recommendations were introduced. The FSB, motivated by the concern that climate risk was an existential threat to the human race, deemed climate risk to be a financial stability risk and set out guidance on how financial firms should assess and disclose their approach and exposure to climate risk. This guidance established a four-pillar framework covering governance, strategy, risk management, and metrics.

The direction of travel thus far has been one of divergence across the major economic blocs, justifying concerns about regulatory divergence expressed by the IFC supervisros. The EU's development of rules and regulations pertaining to sustainability has been relentless. The EU's strategy encompasses the development of Sustainable Taxonomies, Green standards, ESG benchmarks, and regulations covering the role of asset managers, investment products, and financial advice, with proposals now to extend regulations to 'ESG rating' agencies. To date, disclosure requirements have related to products. The EU definition of sustainability is broad, with some 11 mandatory, and 31 voluntary, principal adverse indicators (reporting metrics) in the EU's flagship SFDR. While these metrics may be comprehensive, the EU requirements do not stray into demanding estimates of financial impact. This is perhaps fortunate given that there is little evidence that many of the EU's metric sets possess such causality.

Post-Brexit, the UK has pursued its own path, taking a much narrower approach to

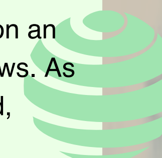


'variables of interest,' sticking closely to the original climate focus of TCFD. The UK's recently finalized SDR incorporates simple entity-level TCFD-like disclosure with a simplified, almost principles-based approach to product disclosures—akin to the incorporation of the ISSB's S2 standard rather than a combined S1 and S2 incorporation.

In the US, the SEC has only recently finalized listed firm requirements, removing scope 3 emissions from scope (sic) - inconsistent with the new ISSB standards. US domestic opinion is more polarized on climate issues than the rest of the world, with a group of US States planning to challenge the SEC's authority to impose these more limited climate risk requirements.

The release of the ISSB S1 and S2 standards should hopefully mark a significant evolution in sustainable finance towards more transparency, and standardization in reporting, establishing global requirements for sustainability and climate-related financial disclosures.

Their focus is on the impact of these risks on an entity's performance, position, and cash flows. As regulatory divergence has already occurred, perhaps, the most that can be hoped for is that the ISSB standards prevent further.



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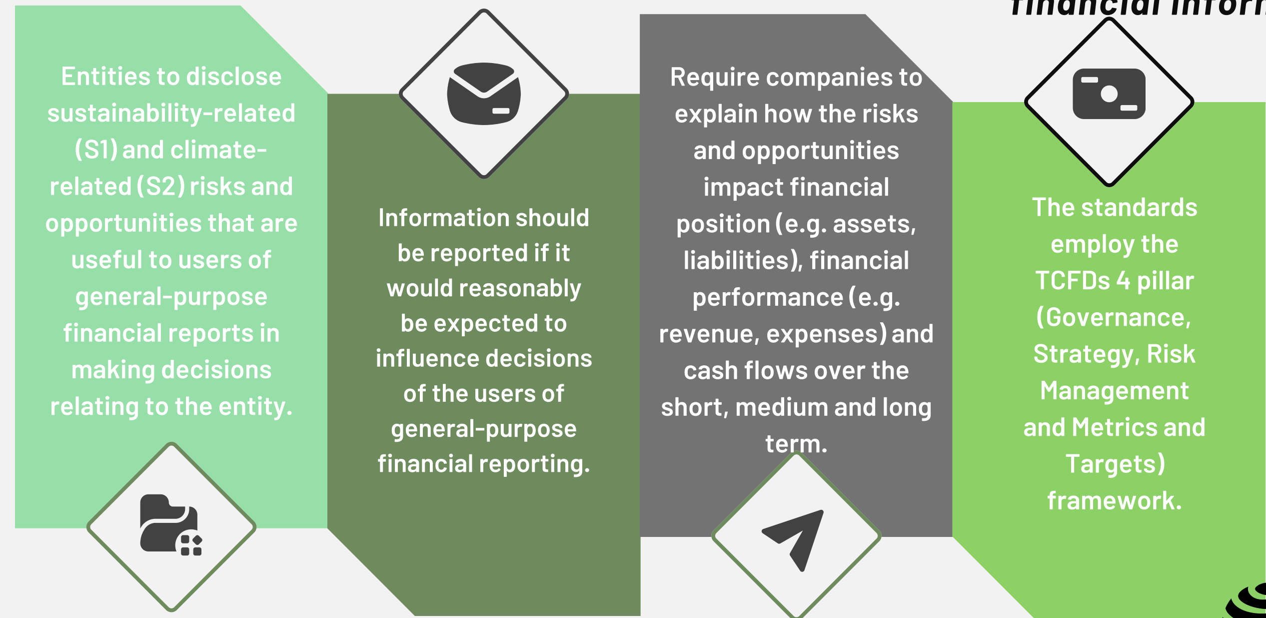
IFRS S1/S2: accounting standards.

The creation of the ISSB was announced at COP26 in 2021 and marked a significant move in sustainable finance, aiming to harmonize the fragmented landscape of ESG reporting. The ISSB's development of IFRS S1 and S2 standards, finalized last year, provides a global framework for sustainability disclosures, focusing on transparency by integrating sustainability risks and opportunities into financial reporting. Both standards adopt the four-pillar framework approach of the TCFD.

The IFRS S1 standard outlines general requirements for disclosing sustainability-related financial information, compelling entities to reveal how sustainability issues affect their business operations, financial condition, and future prospects. Paragraph 35 leaves no doubt that this is an accounting standard:

'Specifically, an entity shall disclose quantitative and qualitative information about: a) how sustainability-related risks and opportunities have affected its financial position, financial performance and cash flows for the reporting period'

The critical factor is the determination of what comprises a sustainability-related risk? The standard points to the Sustainable Accounting Standards Board disclosure topics for example, but the accompanying guidance makes clear that what is deemed to constitute a sustainability-related risk is incredibly broad. It includes labour markets and supply chains as examples of sustainability risks. Such a broad scope makes the approach very difficult to transpose into the regulatory context.



IFRS S2 retains the focus of TCFD on climate risk and climate-related disclosures, carrying over requirements for the publication of financed emissions of banks, asset managers, and insurers. Retaining the four-pillar framework, the similarity is remarkable. But there is still no doubt that at its core, it remains an accounting standard requiring entities to report:

"the effects of those climate-related risks and opportunities on the entity's financial position, financial performance, and cash flows for the reporting period."

S2 requires entities to assess and report on how climate change impacts their strategies, risk management, and financial planning and retains strong risk-based characteristics, perhaps most significantly introducing climate and macroeconomic scenario testing to the assessment of climate resilience requirements.

However, the retention of much of the DNA of TCFD makes S2 more practical and more readily transposable back into regulatory requirements and is is much more likely to be the standard incorporated into national supervisory regimes.

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IFRS S1/S2. TCFD. Compare and contrast

Understanding the distinctions between the TCFD and the ISSB standards is paramount for strategic planning and compliance. Both frameworks aim to enhance the transparency of sustainability disclosures, yet they differ in scope, applicability, and operational focus. And whilst the ISSB standards retain the TCFD four-pillar structure, they are accounting rules.

S1 requirements are deepened to include financial impact and also widened to include a broad definition of sustainability. S2 requirements are deepened to include impacts of climate risk on financial performance and, signficantly, extended by requirement for testing of climate resilience by macroeconomic climate scenario testing.

TCFD was always a voluntary framework that relied on adoption of the guidance by national regulators. There has been quite widespread adoption by the larger economic blocs, effectively making the requirements mandatory for certain types of financial service firms, mainly global banks and insurers, but only limited incorporation across the IFCs as our 2023 survey demonstrated. IFRS S1 and S2, by contrast, whilst presently voluntary, are intended at some point to become mandatory reporting standards. It is clearly in the interest of the accounting profession to make this so. Understanding and integrating both TCFD and ISSB requirements into business operations and reporting practices is going to be likely for the largest firms. This includes evaluating not only climate-related risks and opportunities but also broader ESG factors that could impact financial performance and reputation.

CONTRASTING SUSTAINABILITY STANDARDS

TCFD

- Focus on climate-related financial risks and opportunities.
- Voluntary, with growing regulatory adoption.
- Structured around Governance, Strategy, Risk Management, Metrics & Targets.
- Encourages forward-looking risk assessments.
- Aims for improved investment and lending decisions.
- Global applicability for all business sectors.

ISSB S1

- Comprehensive sustainability-related financial disclosures.
- Includes all ESG aspects, beyond just climate.
- Mandatory for jurisdictions adopting ISSB standards.
- Emphasizes materiality and impact on financial performance.
- Global baseline for sustainability reporting.
- Integrates with financial statements.

ISSB S2

- Focused specifically on climate-related disclosures.
- Aligns with TCFD recommendations.
- Requires scenario analysis for climate risks.
- Mandates disclosure of climate-related targets and progress.
- Global applicability across industries.
- Integrates with financial statements.
- Part of broader ISSB sustainability reporting framework.

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For financial service firms, these frameworks elevate the importance of incorporating climate and sustainability considerations into investment decisions, risk assessment, and governance. This shift likely necessitates developing sophisticated analytical capabilities and strategies that align with these frameworks.

For regulators, the transition creates the conditions to weaken regulatory convergence further. Having started with a framework designed for regulatory purposes, the task for IOSCO and others is how to incorporate accounting standards into regulatory rules where the supervisory mandate is primarily prudential, conduct and financial crime matters.

Consistency of required reporting is the $64 million issue. There are numerous metrics for regulators to choose from in developing their format for compulsory reporting. The manner in which financial impact may be assessed may be prescriptive or discretionary, as can requirements around resilience testing.

From the regulatory perspective, the key principle must be investor protection and whether the climate risk assessment and/or disclosure is relevant, or relates to, or has a potential impact on, client assets and portfolios.

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IFCs and sustainable finance.

Our recent report (2024, the year sustainable finance goes offshore) revealed that the adoption of international standards and the implementation of rules on sustainable finance across the IFCs has been limited to date. Despite widespread government commitments to action on climate change and broader sustainability (the commitment to broader issues being more pronounced across Caribbean and India Pacific regions), only a third of supervisors reported having implemented some rules on sustainable finance. Where rules had been implemented, this was mainly in banking and insurance sectors - the original focus of TCFD - with a few specialist fund regimes and next to nothing in the fiduciary space.

Citing the catalyst of the finalization of the ISSB standards in 2023, all supervisors reported that they were now in the process of planning to implement international regulations. Regulatory pressures are set to be the primary driving force for sustainable finance moving forward across the IFCs as every supervisory body reported that consistency with international standards ranked as the most important factor to them in this area.

The strategic direction is clear: to embed sustainability into the fabric of regulatory requirements across sectors, including banking, insurance, fiduciary and investment funds. This commitment is driven by the objective of ensuring global regulatory coherence. But while IFCs have experienced growth in commitment to sustainable finance, driven by global awareness and regulatory frameworks, the issue is now how to smoothly adopt these new global standards.

The ISSB Catalyst

'IOSCO now calls on its 130 member jurisdictions,...to consider ways in which they might adopt, apply or otherwise be informed by the ISSB Standards within the context of their jurisdictional arrangements, in a way that promotes consistent and comparable climate-related and other sustainability-related disclosures for investors'

IOSCO, June 2023

Excerpts of supervisory responses to ISI survey

'In order to align with other national regulatory bodies, we will introduce agreed-upon disclosures, including ESG disclosure guidance for listed companies, supplemented by SDG core indicators. We will then amend the [ ] rules to make IFRS S1 and S2 compulsory standards.'

'We are currently in the process of developing ESG guidelines for Investment Funds. IOSCO, in its press release dated July 25, 2022, declared its endorsement of the ISSB's sustainability-related Financial Disclosure Standards. As a member of IOSCO, we are still considering the appropriate approach for implementing these standards. Additionally, we are in the process of creating a reporting template for the implementation of IFRS S1 and IFRS S2 for licensees.'

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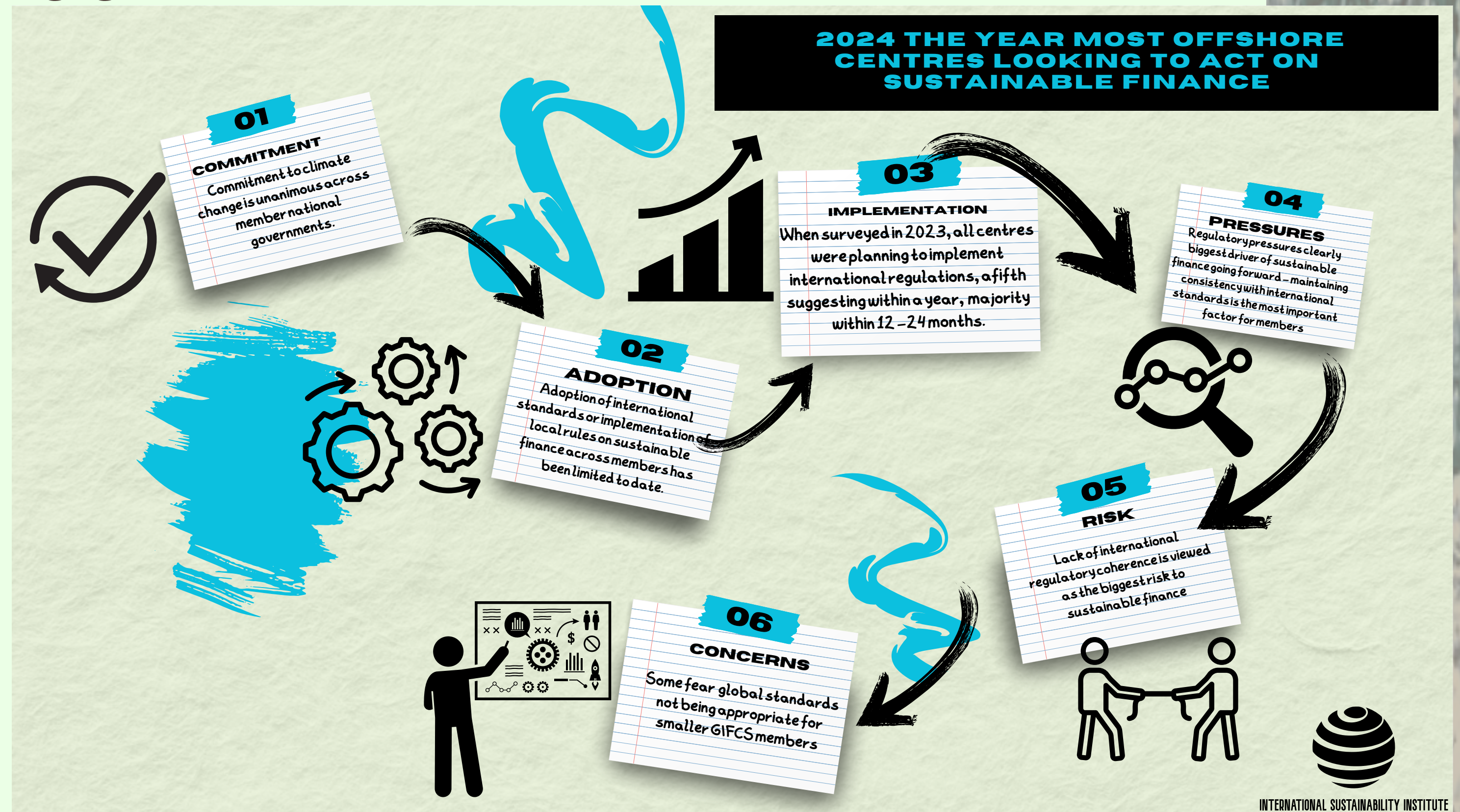
Issues with incorporating global standards.



The lack of international regulatory coherence is a significant concern. Already across the major economic blocs, we have seen divergent standards emerge. Incorporating ISSB standards into national requirements is not straightforward, not least because of the complication of making accounting standards relevant to regulatory frameworks. Neither does the broader remit of IFRS S1 lend itself to the regulatory sphere. Indeed, whether there is a regulatory mandate is questionable for such a generalist approach. At most, for those that do look to adopt S1 in some form, we envisage nothing more than a limited and vague requirement for firms to ensure that ESG type factors (with no prescription of what) are taken into account.

There are good prospects for widespread incorporation of S2 because of its commonality with TCFD and because climate is deemed a financial stablity risk. The TCFD framework is already quite widely adopted providing examples for implementation. It is a simple regulatory affair to impose climate-related governance requirements - that is setting formulaic requirements for Boards, for risk management frameworks, and for strategic deliberations, to all consider climate risk.

The problematic point is articulating the specific requirements on how those risks should be quantified and reported, that is what metrics should be calculated and disclosed, how to transpose the requirement to report on financial impact and how to transpose climate resilience assessments and scenario testing. This being a major potential source of regulatory divergence.

Despite TCFD guidance being published some seven years ago, our research demonstrated that very little reporting of emissions metrics takes place across the IFCs. And this with up to a third of regulators reporting banks and insurers claiming to have adopted TCFD under parent group direction.

The guiding principle must be whether the climate risk assessment and/or disclosure is relevant, or relates to, or has a potential impact on, client assets and portfolios. Emissions of firms' own operations might very well be interesting, but unless these pose a risk to the ongoing viability of the business, it is difficult to suggest these should fall within the scope of supervisory interest.

Regulators would do well to bear in mind that firms will not disclose unless mandated. In Guernsey, the GFSC's gentle suggestion through its corporate governance code (which applies to all company Boards) that firms consider what metrics they might wish to publish, the evidence is that not a single entity has chosen to do so as a result to date.

In introducing climate risk requirements for banking, insurance, and the funds and pensions sectors, IFCs can look to the previous experience of the larger jurisdictions. Lessons can be learned. For trust and corporate service providers, no such standards already exist, there is no previous path to follow.

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Developing requirements for the fiduciary sector

The three main sources of potenital divergence in incoporation of global standards are the 1) specifics of reportable metrics, and 2) how supervisory requirements incorporate the new ISSB requirements of reporting of financial impact and 3) how supervisory requirements incorporate the new ISSB requirements of testing of climate resilience (ie scenario testing).

In banking and insurance, there is a previously trodden path of TCFD for IFC supervisors to use as a guide when introducing climate and sustainability requirements in their supervisory frameworks. In securities, where the reported concerns with regulatory divergence are greater as supervisors attempt to incorporate ISSB standards, there are still existing regimes to look to for guidance.

For the fiduciary sector, there is nothing to guide GIFCs members on the issue. Other than AML, the only supervisory standard relating to TCFPs is the principles-based conduct of business rules established by GIFCs itself in 2014.

Understanding where the incidence of supervisory requirements needs to fall is key to development of regulations. It is clear that in banking, climate risk is a prudential risk pertaining to the balance sheet - the supervisory focus naturally follows. The main question is where should the requirements apply for the supervision of the fiduciary sector? Our guiding principle is whether the climate risk assessment and/or disclosure is relevant or relate to, or has a potential impact on, client assets and portfolios.

Following this approach, it is clear that TCSPs have a crucial role in ensuring that climate-related considerations are integrated into the governance, strategy, and risk management of client assets and structures. This involves:

- Identifying and disclosing climate-related risks and opportunities.
- Integration of climate considerations into governance and strategy.
- Assessment and enhancement of the climate resilience of client assets.
- Provision of transparent reporting and establishment of clear performance metrics.

This approach is consistent with the modern 21st Century view of Fiduciary Duty. We have long argued that this duty makes it contingent on TCSPs to ensure that, while undertaking the activity themselves is not a requirement, they have a duty to ensure that clients' assets are assessed for climate risk.

If the responsibility is not placed squarely on the TCSP to ensure these assessments are made, and being specific about testing of climate resilience and financial impact, sustainable finance rules for the sector will be meaningless.

Conclusions.

We undertook our survey of IFC supervisors in the summer of 2023, almost coincident with the publication of the final ISSB standards which was accompanied by statements of support from IOSCO and endorsement of the TCFD.

After that euphoria, perhaps the reality of transposing accounting standards back into a regulatory framework has taken hold, and there has been little public progress of implementation of ISSB standards. IOSCO has been noticeably quiet on the topic, perhaps as it tries to grapple with the various issues, as we raise in this paper, that could be sources of regulatory divergence. As we noted, other recent developments have too contributed to divergence.

The most enthusiastic protagonists of the ISSB standards have been the large global accountancy groups who might be argued have a vested interest and have a somewhat captive global corporate client base. However the broad remit of IFRS S1 does not lend itself to the regulatory sphere. Indeed, whether there is a regulatory mandate for such a generalist approach is questionable.   IFRS S2 on the other hand, retaining the orginal climate risk focus of TCFD, is likely to be widely incorporated into national regulatory regimes.

Implementation of streamlined sustainable finance regulations - that is incorporating IFRS S2, climate risk reporting standards - should be a relatively straightforward exercise for a large portion of the offshore sector given the example set by implementation by many of TCFD.

The key areas for deliberation being how to incorporate climate risk assessments and scenario planning and the perennial issue of the choice of reportable metrics.

There are some trickier issues to navigate for the trust sector. But in order for the sustinable finance committments of the offshore sector to remain credible this sector must be in scope of regulations.

Even a watering down of requirements would undermine the integrity of regulations and the commitments of national governments to sustainability.   A step which we believe would harm the reputation of individual jurisidictions and the IFC community in the court of global public opinion.

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About the International Sustainability Institute ('ISI')

The ISI provides advocacy and advisory services in sustainable finance focusing on the private wealth sector and the International Finance Centres.

Leveraging the expertise of its founder, Dr Andy Sloan, economist, and expert reviewer for the IPCC, whose career spans three decades working at the most senior levels in international policy, the ISI contributes to global thinking on strategy and policy in these policy areas by way of discussion papers and media commentary.

It provides advisory services and publishes a forward-looking core research progamme, retaining a philosophy of being open to considering proposals and commissions.

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