

# Sustainable Finance Research Platform



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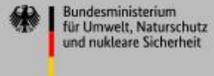


Frankfurt School  
FS-UNEP Collaborating Centre  
for Climate & Sustainable Energy Finance



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**Discussion series on the final report of the German Sustainable Finance Committee**

## **How Does the Understanding of Materiality Affect Non-Financial Reporting?**

23 March 2021, 15:00–16:30

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# Discussion series on the final report of the German SF-Committee

**Wednesday, 10 March 2021**

*Die Frage nach dem Impact – Wie erzielen Finanzprodukte eine transformative Wirkung?*

**Friday, 12 March 2021**

*Bewertung von Transitionsrisiken – Wie kann ein einheitliches Stresstest-Szenario zur realwirtschaftlichen Transformation beitragen?*

**Tuesday, 23 March 2021, 15:00–16:30**

*How Does the Understanding of Materiality Affect Non-Financial Reporting?*

[wpsf.de/veranstaltungen](https://wpsf.de/veranstaltungen)

# Programme

15:00–15:05	<b>Introduction</b> Prof. Dr. Frank Schiemann (Universität Hamburg)
15:05–15:15	<b>Perspective of the Sustainable Finance Committee</b> Prof. Dr. Alexander Bassen (Universität Hamburg)
15:15–15:20	<b>Materiality Definitions and Applications in Standards &amp; Guidelines</b> Raphael Tietmeyer (Universität Hamburg)
15:20–15:25	<b>Research Perspective on Materiality</b> Theresa Spandel (Universität Hamburg)
15:25–15:45	<b>Scope &amp; EU Perspective</b> Mathilde Bossut & Ingmar Jürgens (Frankfurt School of Finance & Management)
15:45–16:30	<i>Questions, Comments, Discussion</i>

# Shifting the Trillions

A sustainable financial system  
for the great transformation

Prof. Dr. Alexander Bassen  
Universität Hamburg  
Research Group Sustainable Finance  
Member of the Sustainable Finance Committee

**31 Recommendations**  
by the Sustainable Finance Committee  
to the German federal government

# About the Sustainable Finance Committee

- The Sustainable Finance Committee was appointed by the Federal Government for the duration of the current legislative period. Its 38 members are practitioners from the financial and the real economy, civil society and academia
- The Committee advises the German government to pursue its aim to develop Germany into a **leading centre for sustainable finance**. In addition, the Committee advises the Federal Government on its positioning in national, European and international discussions on sustainable finance.
- In its final report, the Sustainable Finance Committee has developed **31 recommendations for a national Sustainable Finance Strategy** of the German government.
- The Sustainable Finance Strategy aims to support the financial sector in financing the real economy activities necessary to **achieve the sustainability goals of the United Nations and implement the Paris Climate Agreement**.

# A sustainable financial system for the Great Transformation

- The climate crisis, digitalization and globalization are drivers of a **fundamental transformation**. **Shaping** them **successfully** is the key for the future viability and competitiveness of the Germany economy.
- Significant investments are necessary to make production methods, supply chains and business models future-proof. The financial economy has therefore a key role.
- Changes are, on one hand, necessary for the **financial economy** to **mobilize** and to **leverage** those **resources** and, on the other hand, to **correctly assess opportunities and risks** of the transformation.
- This leads to requirements for:
  - A coherent political framework,
  - Integrated and forward-looking company reporting,
  - Research and systematic knowledge-building,
  - Sustainable financial products, and
  - Building up institutional capacities.

# Future-oriented and integrated reporting

- As a basis for sustainable finance, firms shall report their transformation strategies and their effect on the environment and society in a **transparent, comparable and future-oriented** manner.
- The Committee recommends the German government to:
  - Extend the „non-financial“ reporting obligations at the EU level for firms with >250 employees as well as for companies with special transformation relevance and transformation risks,
  - Introduce a unitary reporting obligation at the EU level of substantial sustainability data within the annual report and to control such,
  - Introduce a TCFD based reporting and to anchor an appropriate comprehension of risk and materiality into the legal framework,
  - Make ESG data available at the EU level through a database that includes raw ESG data,
  - Obligate financial institutions to disclose sustainability risks in credit allocations as of a specific threshold,
  - Set reporting to a standardized transformation scenario in order to quantify transformation risks and opportunities, resiliently and comparably.

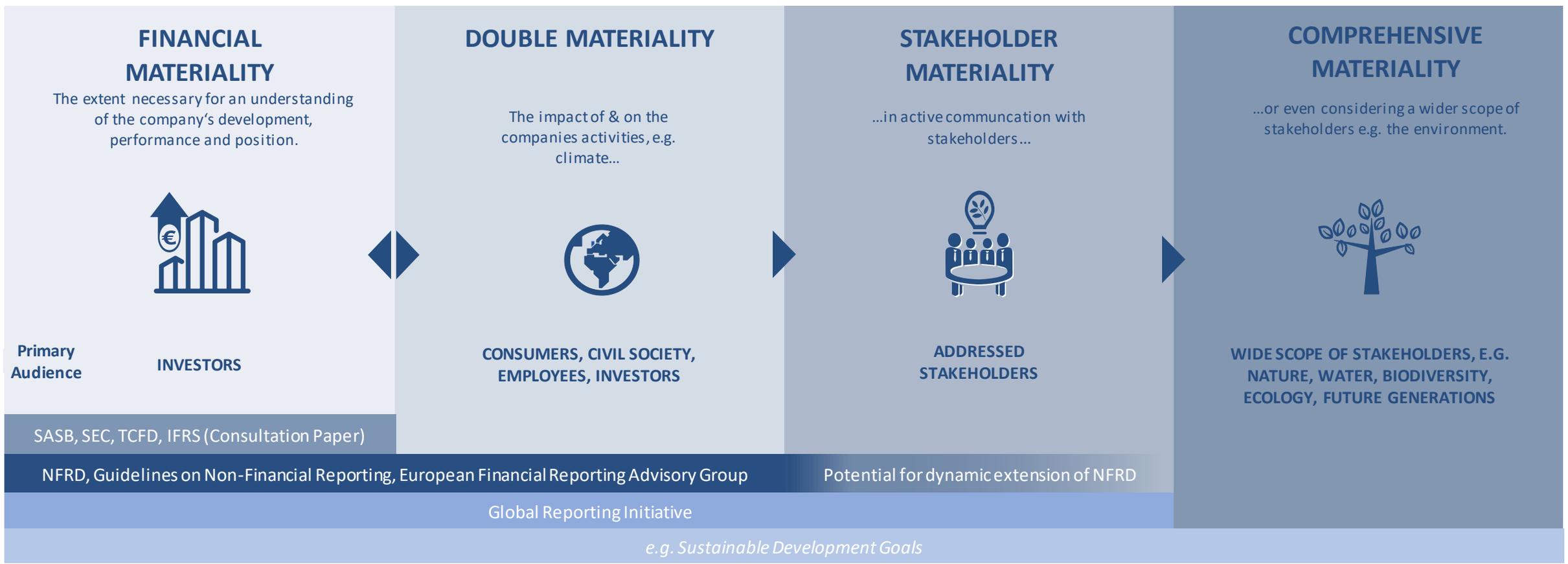
# The double materiality principle

- Following the **double materiality principle**,
  - the effects of ESG issues on the reporting company should be taken into account
  - as well as the effects of the reporting company, its products and services and its business relationships on the environment and society.
- This enables **methodologically well-founded impact measurements**, which can lead to comparable conclusions about the sustainability of portfolios, companies or individual products.
- After the establishment of a corresponding reporting practice, financial markets participants can
  - identify which companies are pursuing the transformation path to achieve the Paris climate goals and the goals for the sustainable development of the 2030 Agenda
  - and thus increase their own resilience and competitiveness
- The Committee recommends the German government to actively engage in the review process of the NFRD and support this revised definition of materiality in sustainability reporting.

# Materiality Definitions and Applications in Standards & Guidelines

Raphael Tietmeyer (Universität Hamburg)

# Materiality Definitions and Applications in Standards & Guidelines



Own representation of: [https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52019XC0620\(01\)&from=EN](https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52019XC0620(01)&from=EN)

# Research Perspective

Theresa Spandel (Universität Hamburg)

# Research on the **financial materiality** of sustainability issues

In how far does the capital market account for financially material\* vs. financially immaterial sustainability disclosures and performance? (\*as defined by the Sustainability Accounting Standards Board (SASB))

## *Key findings*

**Capital markets account for financially material sustainability items, while they seem **not to account for financially immaterial items****

*Example (Khan, Serafeim & Yoon, 2016)*

- Stock portfolios with good ratings on financially material sustainability issues significantly outperform stock portfolios with poor ratings for financially material items
- These differences are not found for financially immaterial items

## *Implications*

- Although certain financially immaterial items might be material to certain stakeholders, the capital market does not seem to account for them
- It is essential that policy makers identify and address those items specifically

# Research on the perceptions of non-financial materiality

How is materiality of sustainability items perceived/ defined?

## *Key findings*

### **1. Materiality is an ambiguous concept**

- Different, localized interpretations of the concept of materiality emerge (Edgley, Jones & Atkins, 2015)
- Different stakeholder groups perceive sustainability items' materiality differently (Reimsbach, Schiemann, Hahn and Schiedchen, 2020)

*Example:* Investors perceive the topic “energy” as more material than “biodiversity”, while both topics are equally material to potential employees

- During the materiality determination process, different stakeholder groups compete to have “their” issues classified as material (Fasan and Mio, 2017)

# Research on the perceptions of non-financial materiality

How is materiality of sustainability items perceived/ defined?

## *Key findings*

### **2. Non-financial reporting standards impact the perception of materiality**

- Issues perceived as immaterial in the absence of regulation can *become material* when regulation/ standards are introduced (Rogers & Serafeim, 2019; Spandel, Schiemann & Hoepner, 2020)

*Example:* Following the SASB standards' publication dates, firms with low performance in material sustainability issues are penalized, while firms with high performance in material sustainability issues are rewarded (Spandel, Schiemann & Hoepner, 2020)

## *Implications*

### ➤ Definitions of materiality matter!

- Adopting a narrow definition of materiality in the NFRD would contribute further to the understanding of materiality in narrow financial terms; the perceptions of stakeholders, who define materiality differently, would be undermined
- Adopting a stakeholder-inclusive definition would enhance the understanding that materiality is perceived differently by different stakeholder groups, and that these perceptions need to be assessed and considered

# Scope & EU Perspectives

Ingmar Jürgens and Mathilde Bossut (Frankfurt School of Finance & Management)

*with inputs from Malte Hessenius (Climate&Company) and Diego Delgado (Frankfurt School of Finance & Management)*

# Revision of the non financial reporting directive (NFRD)

- Non-financial disclosure obligation for companies > 500 employees. (since 2018)
- June 2019: Guidance on climate-related reporting
  - specification of non-binding guidelines (2017) and adoption of TCFD recommendations.
- Revision of NFRD by April 2021.
  - Goal: Shape a unified sustainable finance system
  - Open consultation on eight core topics
  - Expectation: implementation of guidelines in NFRD.

# NFRD – starting point

## Current definition of materiality

Double materiality: Introduced with the “non-binding guidelines on reporting climate-related information”

## Current scope of the NFRD

EU rules on non-financial reporting only apply to **large public-interest companies** with more than 500 employees. This covers approximately 6,000 large companies and groups across the EU, including

- listed companies
- banks
- insurance companies
- other companies designated by national authorities as public-interest entities

# Highlights from the EU Public consultation

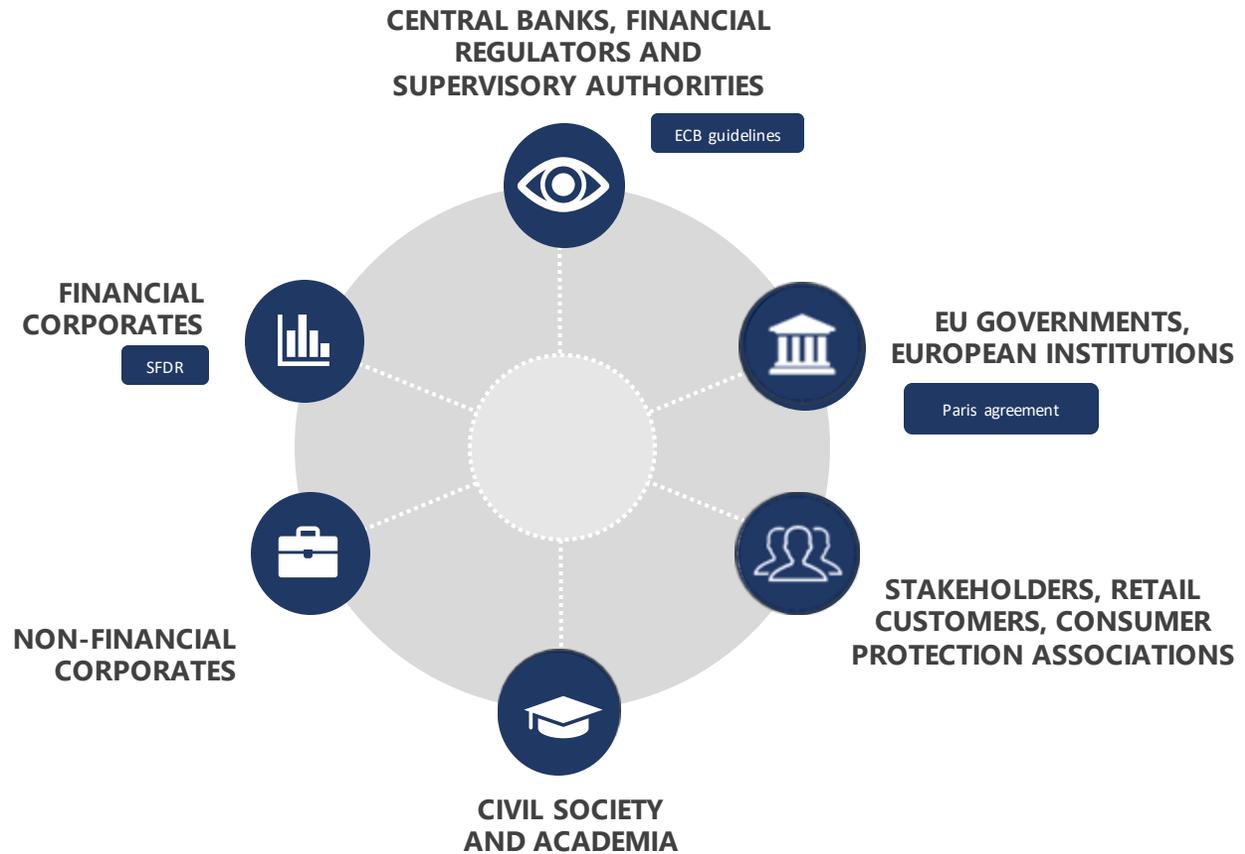
	SCOPE	DEFINITION OF MATERIALITY
ESMA, EBA, EIOPA (Joint letter)	All small, medium-sized and large issuers BUT lighter disclosure requirements for SMES	No reference
European Banking Federation	All listed companies + companies from sectors with a high transition risk regardless of the size of the company	Double materiality
AMF	250+ employees and + €40 million in turnover and/or a €20 million balance sheet total	Need of clarification, coverage of more topic (e.g. governance)
EFRAG	Include SMEs « in a proportionate manner »	Double materiality and Stakeholder materiality

# NFRD: still serving its purpose?

## Towards an extended scope and definition of materiality ?

- New disclosure needs driven by an evolving regulatory environment
- The chosen scope and definition of materiality should be coherent with needs of European financial market participants:
  - Sustainability risks vs. impact
  - Financial vs. environmental relevance

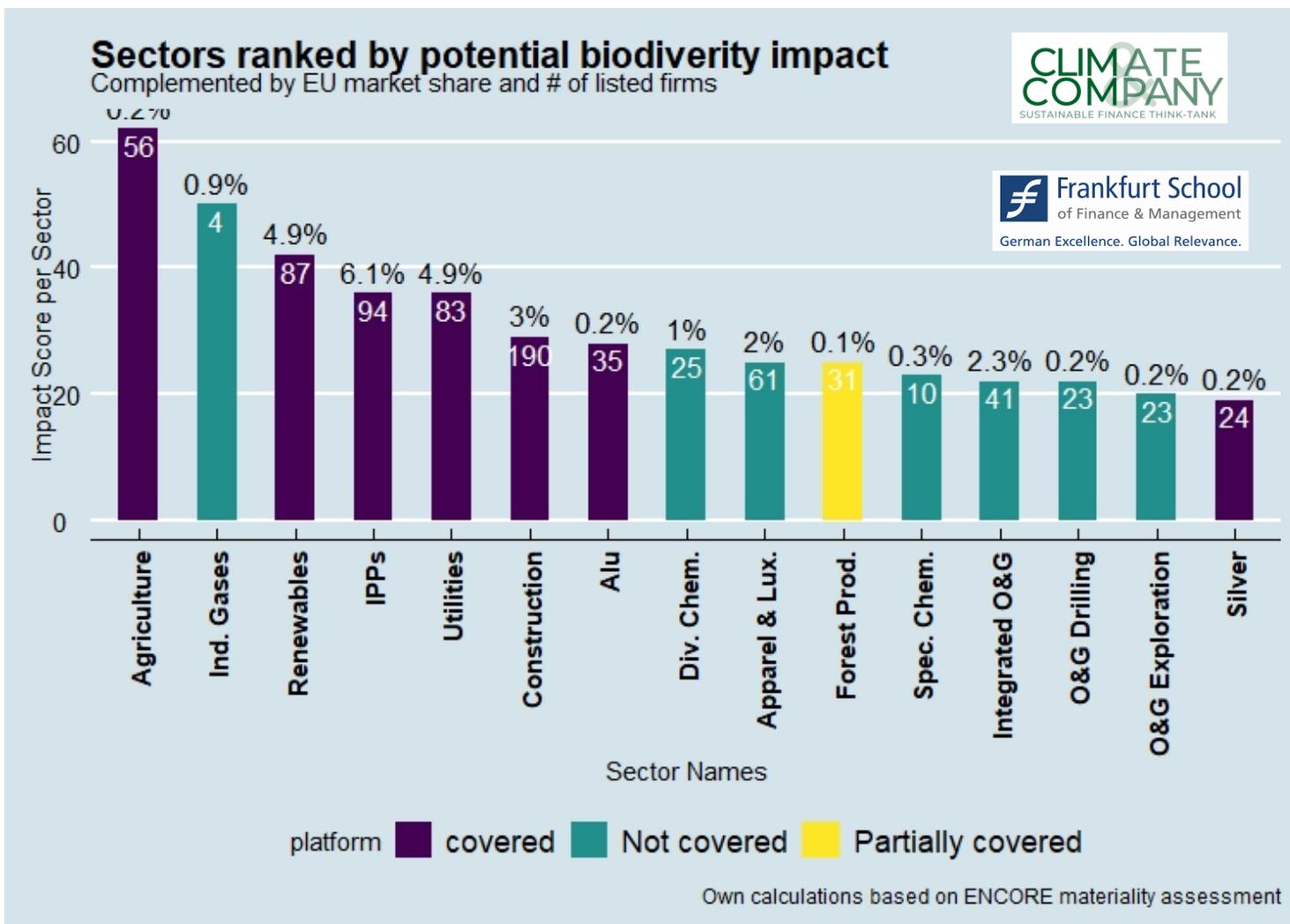
**= It is important to align the scope and materiality definitions of the NFRD with the evolving reality**



# Emerging research questions:

- How much of the environmental impact and risks are currently captured by the NFRD?
- What are the right metrics to define the scope of the NFRD in line with relevant impacts and risks?

# Example: Biodiversity and the (potentially) most relevant sectors (top 15)



## Priority sectors:

- Agriculture has the highest priority (due to 9 potentially harmful business processes);
  - Renewables and Utilities (due to potential impacts along biomass, geothermal, solar and wind energy, plus transmission);
  - Chemicals & Gases;
  - Mining (Aluminium, Silver, Copper, Gold, ...);
  - Extractives (Drilling, Exploration)
- Keep in mind:
  - This analysis is based on potential impacts!

Note: The percentages present the % of market capitalization of ~4500 major listed EU27 equities (Source: WORLDSCOPE). The number shows the corresponding number of firms. As both numbers are based on a GICS to NACE mapping, some overlaps exist.

# Towards an extended scope: an example

- **Biodiversity priority sectors:** agriculture, forestry and fishing are sectors widely recognized for having a high biodiversity footprint.
- However, these companies play a negligible role in the stock markets
- **Indicative analysis “Nace Sector A”:** Listed EU27 vs. non-listed firms in Germany

	EU27 publicly listed	Non-listed only Germany
#of firms	#32	#11597
#of employees	~ 12k	~ 120 k
#of firms > 500	5	9
Total Revenue	~ 2 100 000	~ 17 300 000 <sup>1</sup>
Total Assets	~ 3 300 000	~ 45 300 000 <sup>2</sup>

Data source: Bureau van Dijk, AMADEUS

Research: Hessenius, Delgado, Bossut, Jürgens,

Footnotes: 1), 2): For both entries missing values were replaced with estimated based on the number of employees.

# Scope: What are the most meaningful metrics?

- Which factors are strongly correlated with an environmental impact and could hence inform the definition of the scope for non-financial reporting?

- Example from the literature for an estimation model for GHG-emissions:

- $$\log(CO2_i) = \beta_0 + \beta_1 \log(REV_i) + \beta_2 \log(CAPX_i) + \beta_3 \log(PPDEP_i) + \beta_4 \log(Intan_i) + \beta_5 GMAR_i + \beta_6 LEV_i + \sum_{k=1}^n \gamma_k Sector_j + \varepsilon_i$$

- *CO2 = CO2 in tonnes, logged*

*REV = Total Revenue (i.e., firm output), logged*

*CAPX = Capital Expenditures (i.e., investment), logged*

*PPDEP = Property, Plant and Equipment Net divided by depreciation expense (i.e., asset age), logged*

*Intan = Intangible Assets, logged*

*GMAR = gross margin*

*LEV = long-term debt divided by total assets (i.e., leverage ratio), logged*

Source: Based on: The Relevance to Investors of Greenhouse Gas Emission Disclosures PAUL A. GRIFFIN, DAVID H. LONT and ESTELLE Y. SU, Contemporary Accounting Research Vol. 34 No. 2 (Summer 2017) pp. 1265–1297

# Scope: What are the most meaningful metrics?

Utilities    Cons. Discr.    Cons. Stap.    Energy    Financials    Health Care    Industrials    Info. Tech.    Materials    Telecom.    All S&P 500

Panel A: Model 1 and other variables

		Utilities	Cons. Discr.	Cons. Stap.	Energy	Financials	Health Care	Industrials	Info. Tech.	Materials	Telecom.	All S&P 500
<i>GHGE</i>	Discloser	32,500,000	1,616,927	2,295,960	18,800,000	417,935	546,548	3,462,844	504,563	12,000,000	3,741,093	6,320,279
	Nondiscloser	21,200,000	542,143	1,773,328	6,597,191	463,769	245,559	677,850	133,536	2,903,482	1,767,260	1,960,292
	Signif.	***	***	ns	***	ns	***	***	***	***	***	**
log <i>GHGE</i>	Discloser	16.77	13.48	13.78	15.93	11.81	12.43	13.84	12.11	15.22	14.66	13.61
	Nondiscloser	16.51	12.60	13.89	14.67	11.11	11.71	12.60	11.16	14.59	13.33	12.58
	Signif.	ns	***	ns	***	***	***	***	***	***	***	***
log <i>CAPX</i>	Discloser	21.27	19.94	20.01	22.23	12.08	19.70	20.18	19.59	20.12	22.32	19.10
	Nondiscloser	20.96	19.10	19.99	20.93	17.08	18.78	19.31	18.47	19.26	20.44	19.03
	Signif.	***	***	ns	***	***	***	***	***	***	***	ns
log <i>REVT</i>	Discloser	22.96	23.50	23.45	23.80	23.25	23.32	23.48	22.77	23.04	24.32	23.26
	Nondiscloser	22.77	22.74	23.61	22.64	22.31	22.58	22.86	21.82	22.28	22.40	22.55
	Signif.	**	***	ns	***	***	***	***	***	***	**	***
log <i>PPEDP</i>	Discloser	3.38	2.57	2.74	2.81	2.00	2.03	2.69	1.95	2.88	2.45	2.50
	Nondiscloser	3.38	2.37	2.75	2.93	1.97	2.04	2.45	1.96	2.98	2.62	2.36
	Signif.	ns	ns	ns	**	ns	ns	***	ns	**	ns	***
log <i>MCAP</i>	Discloser	23.08	23.22	23.68	24.29	23.67	23.89	23.52	23.46	23.14	24.36	23.55
	Nondiscloser	22.85	22.80	23.23	22.98	23.07	22.99	23.05	22.80	22.42	22.75	22.91
	Signif.	**	***	***	***	***	***	***	***	***	***	***

# Conclusions

- Important to align the scope and materiality definitions of the NFRD with the evolving reality
- Several arguments point in the direction of the need to expand the scope of the NFRD
  - The assessment of the consultation
  - The exemplary illustration of the composition of sector NACE.A
- It will be important to re-consider how the reporting scope will be defined
  - The existing literature provides examples how this could be done from a GHG emissions perspective and identifies relevant metrics, such as assets or turnover
  - For other environmental objective the parametrisation of estimation models may be challenging
- Both scope related questions could be informed by further empirical analysis

# Next steps – EU sustainable finance agenda

- Adoption of the Delegated Act on taxonomy: second half of April (scheduled for adoption by the "college" (i.e. de Commission) on April 21. This will be accompanied by a Communication.
- Publication of the NFRD Review by the COM and next phase in the legislative process, with role for Council (i.e. also BReg) and EP (Probably April Q2 2021).
- The Commission plans launching a public consultation on the draft delegated act (for Art.8) in April 2021.
- ESA's Joint Consultation on Taxonomy-related sustainability disclosures: open until 12 May 2021
- Publication of Renewed SF Strategy (probably June, Q2 2021)
- Publication and start of legislative process EU Green Bond Standard (probably June, Q2 2021)
- Publication of draft Taxonomy Delegated Act on Article 8 (probably June 2021)
- Publication of draft on Sustainable Corporate Governance (probably June 2021)
- Publication of the first draft criteria for the further development of the taxonomy for environmental objectives 3-6 of the Taxonomy Regulation of the Platform on SF (probably September 2021)
- Publication and start of legislative process European Single Access Point (ESAP) to financial and non-financial information (Q3 2021).
- Publications on Extended Taxonomy (Significant Harm, No Significant Impact, Social; probably end of Q4 2021)

# Thank you very much for your attention!

## Your questions and comments are very welcome.

# ANNEX – additional slides

# HIGHLIGHTS FROM THE EU PUBLIC CONSULTATION

- **Consistency with other legislative initiative** (e.g. Regulation on sustainability-related disclosures in the financial services sector, prudential disclosure requirements foreseen, EU Taxonomy, Human right due diligence...)
- Joint with annual report
- Independent review
- Greater supervision and monitoring, enforcement mechanism and penalties
- Standardisation, even digital standardized reporting, machine-readability
- Different level of reporting (listed companies VS unlisted; mandatory VS recommended VS additional)

