

IIF Green Weekly Insight

Materiality matters

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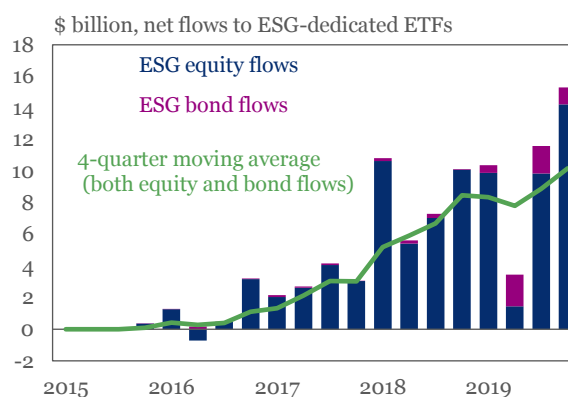
- Sustainability accounting hits the big time
- Overwhelming demand for ESG data—over 55 data/service providers compete in this \$600 million market
- Flows to ESG-dedicated ETFs set to top \$40 billion in 2019—up over 20% from 2018 levels
- New issuance of sustainable debt and loans has surged more than 40% to some \$380 billion in 2019
- Firms are affected differently by ESG issues—further research needed on “materiality” factors at sector and industry level

Can’t understand what you can’t measure: The first comprehensive efforts to develop a national accounting system got started in the 1930s during the Great Depression, and it took over 15 years for the U.S. to publish the world’s first formal national accounts in 1947. Today, national accounting is one of the main building blocks of the global economy, informing both policy design and economic analysis. But amid pervasive international concern about the impact of climate change, parts of the accounting profession are undergoing a remarkable makeover. Sustainable accounting standards for Environmental, Social and Governance (ESG) themes have seen much greater interest over the past five years, e.g. from lenders looking to assess ESG-related risks on their balance sheets, or investors looking at ESG factors as a performance indicator.

Growing interest in sustainability has been also evident in the surge in demand for **ESG data**. While corporate (or sovereign) governance has always been a key factor in lending and investment decisions, many investors are now seeking ways to integrate environmental and social performance data into portfolio allocation decisions and across investment platforms. Against this backdrop, the size of the ESG data market (which includes [over 55 data and service providers](#) at present) is [expected](#) to reach \$745 million in 2020 up from some \$200 million in 2014.

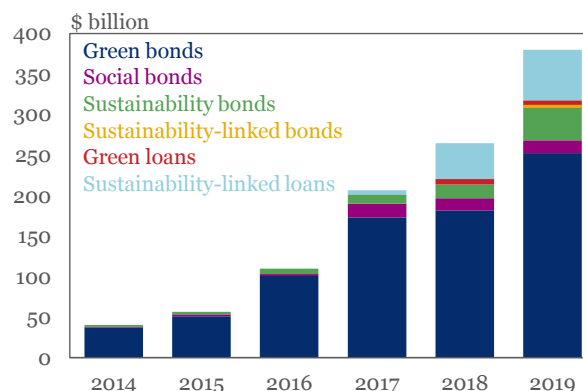
ESG integration has also been driven by strong demand for ESG products, including ETFs. After a record October, ESG-dedicated ETF flows are on track to surpass \$40 billion in 2019, up from \$33 billion in 2018 and just \$12 billion in 2017 (Chart 1). Although flows to equity ESG funds make up the largest share, inflows have been particularly robust in the ESG debt universe. With total sustainability debt and loan issuance growing over 40% to some \$380 billion this year (Chart 2), flows to ESG-focused bond ETFs surpassed \$5 billion in 2019 vs \$0.7 billion in 2018.

Chart 1: Sustainable investing is going mainstream



Source: Bloomberg, IIF

Chart 2: Strong demand for sustainable investment has fueled innovation and new product development



Source: Bloomberg, IIF

Materiality matters - not all ESG issues are equally important to all firms:

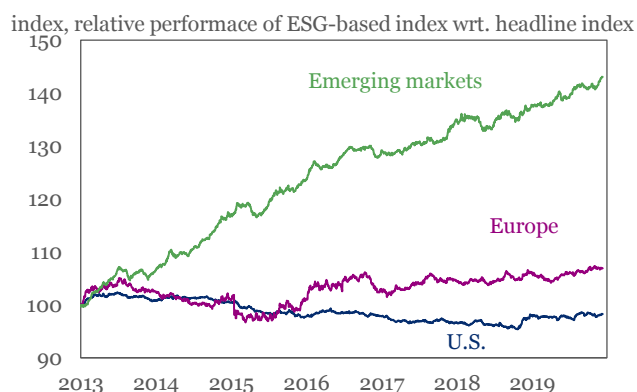
Available data reveal a significant divergence in returns between ESG and traditional indices for emerging markets—and to a lesser extent for European shares (Chart 3). However, it’s hard to determine how meaningful this divergence really is, as availability (and comparability) of corporate data is a major constraint on assessing the impact of ESG factors on performance. While ESG-related reporting initiatives and standard-setters, including [CDP](#), [NFR](#), [SASB](#), [GRI](#), [IIRC](#), [CDSB](#) and [TCFD](#) continue to address data gaps, ESG-focused investment can still mean different things in different jurisdictions (and sectors). Moreover, having too many ESG disclosure regimes can induce reporting fatigue, add to complexity and create confusion. Quantity and quality of disclosure both matter. High-quality disclosure can strengthen investors’ understanding of how companies are operating and can have a material impact on investment decisions. However, quantity—disclosure on too many inconsequential characteristics—could mislead investors and prompt concerns about greenwashing. Moreover, the burden of unneeded disclosure on non-material themes can be high—particularly for small businesses.

To address these challenges, tools such as SASB’s [materiality map](#) can help differentiate between material and immaterial business issues. It identifies 26 sustainability-related business issues (out of more than 200 indicators) that are likely to affect firms’ financial condition or operating performance across 79 industries in 11 sectors (Table 1). For instance, SASB identifies five sustainability key performance indicators (KPIs) for commercial banks:

- **Data security** (number of data breaches, procedures to identify data security risks);
- **Access & affordability** (loans to promote SMEs and communities; products to enhance financial inclusion);
- **Product design & lifecycle management** (sectoral breakdown of credit exposures; description of approaches to integrate ESG factors in credit risk analysis);
- **Business ethics** (money losses as a result of legal proceedings associated with fraud, anti-trust, etc.);
- **Systemic risk management** (practices for incorporating stress tests results—including those related to climate-related risks—into long-term corporate strategy).

There are many viable approaches building on tools like SASB’s materiality map to quantify ESG themes at firm level. These methods are mainly distinguished by their choice of ESG themes and data sources. And there is no single framework or a unique subset of ESG themes that are equally important for each sector or firm—in part reflecting the need for further research.

Chart 3: ESG materiality matters



Source: Bloomberg, IIF

Table 1: SASB Materiality Map – A Snapshot

X: Likely a material issue for companies in the industry

| | Asset managers | Banks* | Insurers |
|--|----------------|--------|----------|
| Environmental | | | |
| GHG Emissions | | | |
| Air Quality | | | |
| Energy Management | | | |
| Water & Wastewater Management | | | |
| Waste & Hazardous Materials Management | | | |
| Ecological Impacts | | | |
| Social Capital | | | |
| Human Rights & Community Relations | | | |
| Customer Privacy | | | |
| Data Security | | X | |
| Access & Affordability | | X | |
| Product Quality & Safety | | | |
| Customer Welfare | | | |
| Selling Practices & Product Labeling | X | | X |
| Human Capital | | | |
| Labor Practices | | | |
| Employee Health & Safety | | | |
| Employee Engagement, Diversity, & Inclusion | X | | |
| Business Model & Innovation | | | |
| Product Design & Lifecycle Management | X | X | X |
| Business Model Resilience | | | |
| Supply Chain Management | | | |
| Materials Sourcing & Efficiency | | | |
| Physical Impacts of Climate Change | | | X |
| Leadership & Governance | | | |
| Business Ethics | X | X | |
| Competitive Behavior | | | |
| Management of the Legal & Regulatory Environment | | | |
| Critical Incident Risk Management | | | |
| Systemic Risk Management (including climate risk analysis) | X | X | X |

Source: SASB, IIF; *Commercial banks