Sustainability Reporting Board EFRAG
Acting Chair
Ms Kerstin Lopatta
35 Square de Meeûs
1000 BRUSSELS
Belgium

| | |
|---|---|
| Date | 8 August 2022 |
| Our reference | |
| Page | 1 of 9 |
| Phone | +31207972401 |
| Email | michael.deinema@afm.nl |
| Subject | AFM response to the first set of draft European Sustainability Reporting Standards (ESRS) |

Dear Ms Lopatta,

The Dutch Financial Markets Authority (AFM) appreciates the opportunity to respond to the consultation on the first set of draft European Sustainability Reporting Standards (ESRS) proposed by the European Financial Reporting Advisory Group (EFRAG). We are pleased to provide you with our comments with a view to promoting reporting standards that can result in relevant, reliable, comparable and understandable information on how corporations take into account sustainability-related impacts, risks and opportunities.

The AFM is an independent market conduct authority that supervises the conduct of the entire financial market sector in the Netherlands: savings, investment, insurance, loans, pensions, capital markets, asset management, audits and financial and non-financial reporting. The AFM is committed to promoting fair and transparent financial markets. Because of these broad oversight tasks, the AFM is a member of various European and global bodies and committees, such as the European Securities Markets Authority (ESMA), the Committee of European Audit Oversight Bodies (CEAOB) and the International Organization of Securities Commissions (IOSCO).

As a member of ESMA, the AFM acknowledges, supports and has actively contributed to ESMA's response to the consultation of the ESRS. Our own response largely echoes and regularly quotes ESMA's response. On some points, however, the AFM wishes to place greater emphasis and elaborate more than ESMA has done. Furthermore, the AFM would like to make some additional comments which in our view could further improve the quality and practicability of the ESRS. Moreover, as a member of the CEAOB and having actively contributed to the CEAOB's response to the consultation of the ESRS as well, the AFM would like to reiterate here two concerns expressed by the CEAOB in their response: (1) the concern that the time pressure to deliver applicable standards will impair EFRAG's ability to fully review the draft ESRS and incorporate comments received in this consultation and; (2) the concern that the description of verifiable information in ESRS 1 is insufficiently attuned to assurance needs.

There are several reasons why the ESRS, as well as the specific points we emphasize and add, are of great importance to the AFM. The Netherlands, which is the AFM's jurisdiction, contains relatively many companies that operate worldwide and its private and institutional investors display relatively high levels of sustainability-related consciousness. The AFM itself has consistently supported national, European and international initiatives to promote sustainable finance and considers the sustainability of financial markets to be a key supervisory and organizational priority.

The AFM supports the EU-wide legislation that has resulted from the Sustainable Finance Action Plan, such as the EU Taxonomy Regulation, the Sustainable Finance Disclosure Regulation (SFDR) and the Corporate Sustainability Reporting Directive (CSRD). In the public consultation that preceded the development of the CSRD, the AFM argued for comprehensive, relevant, comparable and mandatory standards for the reporting of 'non-financial' (sustainability-related) information and also that this information should be audited and verifiable.[1] The AFM welcomes the CSRD's comprehensive topical approach and its focus on double materiality, as the AFM acknowledges that transparency concerning corporations' impact on the environment and societies is of great importance in the transition to sustainable economic activities.

The AFM is markedly concerned, however, that the excessive level of detail, complexity and granularity of the proposed ESRS makes these standards unfeasible for implementation by many corporations, as well as unconducive to adequate reporting of material information and to the adequate verification and supervision thereof by assurance providers and enforcement authorities. Furthermore, it may result in a disclosure overload which will make it hard for users of the resulting information to 'see the forest for the trees' and identify truly significant information.

The AFM has serious concerns as well about the interoperability of the ESRS with the standards proposed by the International Sustainability Standards Board (ISSB). On sustainability matters pertaining to enterprise value creation, i.e. sustainability-related risks and opportunities which may affect a corporation's valuation and value-creation potential, the ISSB standards appear set to become the global baseline. The ESRS, being based on the principle of double materiality, are intended also to provide (in line with the ISSB's ambitions) standards for the reporting of sustainability-related risks and opportunities that affect enterprise value (the financial materiality principle), not only to provide standards for the reporting of the sustainability-related impacts of corporate activities (the impact materiality principle). Diverging from global baseline standards (insofar as these also cover the topics that the ESRS cover) regarding financially material sustainability-related information, runs the risk of requiring EU companies to report information which investors and other stakeholders cannot adequately compare with seemingly similar information reported by companies outside of the CSRD's jurisdiction. This will impede the ability of investors and asset managers who are active worldwide to make investment decisions based on the sustainability-related performance, risks and targets of EU companies. Furthermore, diverging from the global baseline, will saddle many EU companies with the added complexities of converting sustainability-related information produced by their subsidiaries and business partners in non-EU jurisdictions to a divergent EU standard. This risks further harming the feasibility of adequate sustainability reporting by these companies.

[1] AFM's Response to the consultation for the review of the Non-Financial Reporting Directive (8 June 2020).

The AFM also responded to the consultations on the ISSB's exposure drafts on standards for general sustainability-related disclosures (IFRS S1) and climate-related disclosures (IFRS S2) and encourages both the ISSB and EFRAG to make the utmost effort to enable the reporting of fully comparable sustainability-related information worldwide.

The AFM's other main concerns and comments relate to the assessment of materiality, connectivity between sustainability reporting and financial information, the role of deforestation in adequate climate-related reporting and to the conceptualization of the value chains of financial-sector enterprises.

While timely entry into application of the ESRS is important, in light of the volume of the draft standards and the comments EFRAG is likely to receive, the AFM encourages EFRAG to ensure that adequate preparation and discussion time is catered for in the re-deliberation process to ensure that the consultation feedback is properly taken into account.

The AFM's key comments and recommendations regarding the proposed ESRS can be summarized as follows:

**A. Address the disclosure overload problem**

In their current form, the ESRS will not lead to the reporting of corporate information that enables investors and other relevant stakeholder groups to easily identify the main sustainability-related risks, opportunities and impacts of corporations. Moreover, the complexity and sheer volume of required data points and disclosures contained in the proposed ESRS, which go far beyond the requirements set out by the CSRD, will make their adequate application by companies virtually unfeasible. Furthermore, the ability of assurance providers to verify the resulting information will be impeded, as will be the ability of supervisors to enforce the proper applications of these standards.

In order to help mitigate these expected problems, the AFM, following ESMA, recommends in general terms that many standards are deprioritized and made optional instead of mandatory. All performance measurements which cannot be considered as the primary indicator of a required topic or subtopic mentioned in the CSRD should be clearly considered for deprioritization.

Additionally and with the requirements of the CSRD in mind, the AFM proposes that EFRAG removes the unnecessary granularity of required reporting metrics and mandatory key performance indicators (KPI's). In particular, we recommend the removal of requirements to report KPI's per country, per site or per asset. In the AFM's view, this should be replaced by requirements to report at a higher level of aggregation (e.g. world regions), with the caveat that the company should additionally report on particular countries, locations or assets where particularly higher levels of risk or impact have been identified there, thus following a risk-based approach.

Specific required qualitative explanatory descriptions should also be made optional and should be reviewed by EFRAG in terms of their added value from the view of users of sustainability information. For example, the general requirement (in ESRS 1 paragraph 100a) to explain the link between each sustainability-related (transitional) policy and each related measurable target can lead to the reporting of information which is superfluous to (somewhat) knowledgeable audiences when both the policies and the targets are described in familiar general terms.

In the AFM's view, introducing clearer delineations of the reporting boundary (i.e. clarifying how far into the value chain the reporting responsibilities of the reporting entity extend) and of the "long-term" time horizon about which companies are expected to report (which is defined in an open-ended way in the proposed standards), will also facilitate the reporting of more concise, accessible and comparable information. Naturally, in certain topical or industry-specific standards, those delineations could be explicitly extended by EFRAG to account for the context-specific relevance of certain reporting boundaries and timeframes for material sustainability reporting.

Finally, the AFM recommends that clearer and stricter thresholds are defined for what constitutes material information, from the perspective of either impact materiality or financial materiality, in terms of frequency, probability and severity (and combinations thereof). In our view, this will improve the quality of the ESRS by helping to limit the problem of disclosure overload without significant loss to the comprehensiveness and importance of the information that is reported.

**B. Promote interoperability and further alignment with ISSB and GRI standards**

Echoing ESMA, the AFM notes that the CSRD requires that (without diverging from EU legislation and objectives) the ESRS take into account to the greatest extent possible the work of global standard-setting initiatives for sustainability reporting. In light of these requirements, the AFM emphasises that (without lowering the EU's sustainability ambition) global comparability of sustainability reporting requirements should be a key objective of the ESRS. The AFM therefore strongly encourages EFRAG to continue its efforts to build convergence with the future IFRS Sustainability Standards being developed by the ISSB.

The AFM also encourages EFRAG to further increase alignment with the standards of the Global Reporting Initiative (GRI) which currently constitute the most frequently used reporting framework under the NFRD and are especially relevant for the impact materiality perspective. The GRI standards are an important source for the ESRS. However, as stated in the GRI's technical position there is still significant room for greater alignment and convergence.[2] This would enable corporations, which are already applying GRI standards, to implement the ESRS more easily and increase the comparability and understandability of the sustainability reports of European corporations.

[2] https://www.globalreporting.org/media/gsipjvy5/gri-s-submission-to-efrag-s-public-consultation-on-the-first-set-of-draft-esrs.pdf

Specifically, in order to achieve greater alignment, EFRAG should engage in further discussion with the ISSB and GRI to achieve a better mutual alignment of the respective terminology, definitions and architecture of the reporting standards. Alignment on terminology and definitions would be important for users consuming sustainability information under both EU and international standards, as this would enable them to more easily compare the information. Such alignment would also help preparers navigate the different sets of standards when compiling their reporting.

The AFM also notes that, for the architecture of the reporting standards, the ISSB built on the structure developed by the Task Force on Climate-related Disclosures (TCFD), whereas EFRAG has decided to depart from that and develop a more complex architecture. If the architecture of the proposed ESRS is retained, the reconciliation between ISSB standards and the ESRS will not be seamless which may be to the disadvantage of users and preparers. The AFM encourages EFRAG to undertake the necessary work to minimise the differences in architecture while recognising the fact that the TCFD structure was originally developed for financially material information on climate-related issues and that it may, therefore, need adaptations to reflect the wider topical scope and double materiality principle underpinning the ESRS.

Lastly, the AFM strongly recommends that EFRAG engages the ISSB with a view towards achieving clear mutual alignment of the ESRS's 'financial materiality' concept and the ISSB's 'enterprise value creation materiality' principle, in terms of definitions and application guidance. As a step towards convergence, EFRAG could consider basing the definition of 'financial materiality' on that of 'enterprise value creation materiality' and consider changing the naming convention to further align with that of the IFRS Sustainability Standards. More crucially, EFRAG could clarify how impact materiality and financial materiality are interwoven and how, sometimes, impacts that corporations have on society and the environment affect not only external stakeholders but the corporations themselves as well. Both the ESRS and the ISSB's standards tacitly recognize that such impacts can affect the financial prospects (i.e. value creation) of the corporations which generate those impacts.[3] Thus far, however, neither the ISSB's proposed standards, nor the proposed ESRS, clarify the possible relationship between a corporation's sustainability-related impacts and its financial prospects or value creation. The AFM recommends that EFRAG and the ISSB consider and explain how (through which types of mechanisms and under which types of circumstances) corporations' impacts materially affect their own prospects and that EFRAG and the ISSB seek agreement on those matters. In the AFM's recently published response to the consultation of the ISSB's exposure drafts, we have made the same recommendation and included several suggestions on how to envisage the linkages between corporations' impacts and prospects.[4]

[3] In the case of the ESRS, this recognition is evinced by the fact that ESRS 1 indicates that some information may be material in two ways (impact and financial materiality) at once. In the case of the ISSB, it is evinced by the fact that the ISSB's climate-related disclosure standards largely focus on corporate greenhouse gas emissions (i.e. impacts that cause climate change) rather than on possible exposures to the effects of climate change caused by others (e.g. rising sea levels, increased probability of droughts and other extreme weather conditions).
[4] AFM response to ISSB Exposure Draft IFRS S1

## C. Improve materiality assessment

Key to the spirit of the CSRD is that companies report sustainability-related information which is material either from a financial or impact perspective or from both perspectives at once. The AFM is strongly supportive of the CSRD's goal of enhancing the quality of sustainability reporting and ensuring relevant, reliable, comparable and understandable disclosure. It is therefore the AFM's position, in line with ESMA's, that a rigorous materiality assessment by the reporting enterprise needs to be the basis for reporting information that is relevant for the decision-making of investors and other stakeholders. We strongly recommend that EFRAG provides adequate guidance to reporting entities on how to implement the materiality process, including how to determine any entity-specific qualitative and quantitative materiality criteria and how to distinguish between impact materiality and financial or enterprise value creation materiality.

Like ESMA, the AFM does not support the proposed rebuttable presumption, defined in paragraphs 57-62 of ESRS 1, by which every mandatory disclosure requirement is presumed material unless a corporation provides (ad hoc) reasonable and supportable evidence to rebut that presumption per disclosure requirement or group of disclosure requirements. We believe this may provide counterproductive and sometimes even conflicting incentives which may decrease disclosure quality. The problematic aspects of this approach are threefold. Firstly, it may engender a checklist approach to sustainability reporting, whereby corporations take the (impressive amount of) disclosure requirements in the ESRS rather than rigorous materiality assessment as the starting point of their reporting process. Secondly, the rebuttable presumption mechanism is easily interpretable as a 'comply or explain' mechanism, which may encourage only superficial compliance to the CSRD requirements and may reduce both the usefulness of the reported information and effectiveness of supervision. Thirdly, in some cases this mechanism may further aggravate the disclosure overload problem as some corporations may tend to disclose immaterial information to avoid the development of more burdensome supporting documentation necessary to justify the non-disclosure of that information.

In the AFM's view, a strict requirement to disclose only material information (like in financial reporting) is needed in place of the rebuttable presumption mechanism. However, the AFM recognizes that sustainability reporting that employs a double materiality lens, requires materiality assessments which are more complex than those common in financial reporting. Moreover, sustainability reporting is a relatively new field of reporting for many corporations that fall within the scope of the CSRD. The resulting information is also relatively new for investors and other users of corporate information, at least in comparison to financial information. Therefore, the AFM sees the need for extensive guidance on assessing which sustainability-related information is material or not in terms of financial materiality (enterprise value creation materiality) and/or impact materiality.

The guidance provided for materiality assessment should include, among other things, better clarified and stricter thresholds of materiality, more specifications per topic regarding (potentially) affected stakeholders, a clearer definition of the 'long term' time horizon and more examples of what constitutes material information on the basis of both the impact and the financial materiality principle. Furthermore, the guidance provided on impact materiality assessment should ideally be aligned as much as possible with the guidance provided by the GRI, which over the last decades has been the main global standard setter for corporate reporting on matters of corporate sustainability impacts. The AFM would also recommend that EFRAG coordinates with the ISSB to ensure that guidance on financial materiality assessment aligns with enterprise value creation materiality assessments.

**D. Encourage connectivity between sustainability reporting and financial reporting**

The AFM supports effective and clear connectivity between sustainability-related information and financial information contained in financial statements and management reports. We recognize that the CSRD limits the extent to which the sustainability report can be integrated with (other) financial information by demanding explicitly that the sustainability-related information (to be disclosed in accordance with the CSRD) is presented in a separate and clearly identifiable location in the management report in order to facilitate assurance thereof. We strongly support the elements in the application guidance to ESRS 1 (§92 AG 24 and 26) which require corporations to report on the expected sustainability-related impact of future capital expenditures in the future information section of management report. In the AFM's opinion, such information is of great importance to investors and other stakeholders to assess the trajectory that a corporation is on in terms of transitioning to sustainable economic conduct. The AFM would like to encourage EFRAG to further encourage connectivity between the sustainability information and (particularly forward-looking) financial information that corporations report. Corporations should moreover be required to report in clear terms how expected material sustainability-related impacts, risks and opportunities have informed and affected its main strategic decisions and business development decisions. Importantly, the AFM recommends, echoing ESMA, that EFRAG further considers how to best develop a "regime for incorporation by reference," i.e. rules for using references in the sustainability report to material information located in the financial statement or elsewhere in the management report.

**E. Incorporate deforestation in ESRS E1 as a climate-related metric**

The AFM would also like to make a point concerning activities that damage carbon removal and storage, in particular deforestation (and other damage done to 'carbon sinks'). Disclosure requirement 12 in ESRS E1 (DR E1-12) requires reporting on the removal of greenhouse gasses (GHG) in corporations' own operations and value chains and refers explicitly to reforestation as a removal method. The AFM supports the inclusion of reforestation in ESRS E1 but notes that, conversely, deforestation is not considered in the proposed standards relating to climate change. We recommend that deforestation is considered as a material factor in climate-related corporate disclosures, as it plays a significant role in human-induced climate change and is regularly the result of corporate activity. We have noted that the climate-related disclosure requirements proposed by the ISSB (exposure draft IFRS S2) similarly exclude matters of deforestation. The AFM has made the same recommendation to the ISSB, as we make in this letter, to include deforestation in climate-related disclosure requirements.[5] We therefore also encourage EFRAG to engage with the ISSB to develop shared views on how deforestation can be best incorporated into climate-related corporate reporting.

**F. Provide adequate bounded definition of value chains of financial-sector enterprises**

Finally, the AFM would like to raise the point that general conceptions of a corporation's value chain may not be applicable to financial-sector enterprises and recommends that EFRAG considers clarifying and delimiting to what extent the investments made by financial-sector enterprises (and the value chains of the companies they invest in) are part of their value chain. The concerns we have raised above about the disclosure overload problem (and the role that undelineated reporting boundaries play therein) are particularly acute when it comes to the proposed reporting obligations of financial-sector enterprises. For the purposes of sustainability-related disclosures, the relevant value chains of banks, insurance companies, mortgage lenders and other financial-sector enterprises are at present difficult to conceptualize. We are concerned that financial sector enterprises, due to a lack of guidance provided in the ESRS on this point, will not on a consistent basis determine their own relevant value chains. The AFM has noted that the proposed ISSB standards do not adequately address this issue either and neither do the SASB industry-specific standards which are referred to by the ISSB.

We strongly encourage EFRAG to outline an adequate, relevant, bounded and feasible definition of financial-sector value chains in the industry-specific standards which it is developing. Lack of clarity concerning the reporting boundaries for financial-sector enterprises can lead to either underreporting of relevant information or overreporting. The first risk is that financial-sector enterprises do not report material sustainability-related risks (or opportunities) and impacts which they are exposed to or partly responsible for via the companies they finance or invest in. The second risk is that financial-sector enterprises attempt to report on the entire value chain of all the companies in which they hold significant assets, leading to an excessive reporting burden for the financial enterprises themselves and disclosure overload for the users of their sustainability-related financial information. In the AFM's view, both of these risks should be urgently addressed as a financial-sector enterprise potentially holds leverage over large parts of global economic activity. Furthermore, especially when it comes to financial materiality (or 'enterprise value creation' materiality), we recommend that EFRAG engages with the ISSB to coordinate the development of a more detailed definition of financial sector value chains in both the ESRS and international standards.

In case you have any questions or comments please do not hesitate to contact us or Michaël Deinema, Policy Advisor on Capital Markets in the Department of Strategy, Policy and International Affairs (michael.deinema@afm.nl).

[5] AFM response to ISSB Exposure Draft IFRS S2

Yours sincerely,
The Dutch Authority for the Financial Markets

| | |
|---|---|
| L.B.J. van Geest | H. van Beusekom |
| Chair of the Executive Board | Member of the Executive Board |