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Subject	AFM response to ISSB Exposure Draft IFRS S2

Dear Mr Faber,

The Dutch Financial Markets Authority (AFM) thanks you for the opportunity to respond to the ISSB's Exposure Drafts ED/2022/S1 *IFRS S1 General Requirements for Disclosure of Sustainability-related Financial Information* and ED/2022/S2 *IFRS S2 Climate-related Disclosures* (referred to collectively as the 'EDs'). In this letter, the AFM will outline its key general comments on both EDs. We will provide our answers to the questions in the online surveys in the Annex to this letter. We have decided to submit our answers to the surveys concerning ED IFRS S1 and ED IFRS S2 separately, but to accompany both submissions with the same cover letter as some of our key recommendations and general comments concern both EDs. The AFM submits these responses with great appreciation of the ISSB's efforts to develop high-quality international standards for corporate reporting on sustainability-related matters and in order to further contribute to the clarity, relevance and cross-regional applicability and comparability of these standards.

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 global and European bodies and committees, such as the International Organization of Securities Commissions (IOSCO), the European Securities Markets Authority (ESMA) and the Committee of European Audit Oversight Bodies (CEAOB).

As a member of ESMA, the AFM acknowledges, supports and has actively contributed to ESMA's response to the consultation of the ISSB's EDs. 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 of IFRS S1 and IFRS S2.

There are several reasons why the ISSB's EDs, as well as the particular 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 is supportive of 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 CSRD has mandated the European Financial Reporting Advisory Group (EFRAG) to develop European Sustainable Reporting Standards (ESRSs) that cover a wide range of ESG-topics and are designed around the notion of 'double materiality'. The AFM has welcomed 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 has consistently held the view that global consistency and comparability of sustainability reporting is of paramount importance to investors and reporting entities, both within and outside the EU's jurisdiction. Echoing ESMA, we therefore wish to highlight the importance of interoperability between international and European standardization efforts to ensure a better flow of information across sustainable investment chains. The AFM would like to call upon the ISSB to proactively engage with regional standard setters such as EFRAG with the goal of increasing the alignment and interoperability of standards wherever that is feasible. A lack of consistency and comparability of sustainability reporting standards generates confusion for investors who operate across jurisdictions and seek to make investment decisions based on sustainability-related information. Such a lack also generates confusion and additional costs for reporting entities (i.e. corporations) that operate across regional or national jurisdictions, as well as for corporations that operate within global value chains, thus decreasing the chance that corporations produce and report adequate information on the sustainability of their operations and enterprise as a whole.

Regarding the ISSB's single materiality perspective on sustainability reporting, the AFM would like to stress three advantages of applying a wide definition of 'enterprise value creation.' The (social and environmental) impacts that a corporation has on the outside world regularly generate material risks (and sometimes opportunities) for the corporation itself, including transition and physical risks. A wide definition of single materiality should, in the AFM's view, explicitly envisage the feedback or 'boomerang' effects that a corporation's social and environmental impacts may have. Adopting this wide interpretation in the ISSB's Standards would have the advantage, firstly, of requiring reporting entities to provide a fuller picture to investors of the sustainability-related risks and opportunities they face. Secondly, it would be helpful in combatting greenwashing, a pernicious phenomenon which undermines effective sustainable investment.

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

Greenwashing achieves its negative effects by means of unsubstantiated claims which revolve around, in ESMA's words, "alleged societal and environmental impacts of certain financial products or entities" that "do not distinguish finely between enterprise value creation and impact materiality." Greenwashing is often motivated by an understanding on the part of corporations that (perceptions of) their impacts on sustainability affect their financial prospects. Thirdly and finally, it would bring the proposed international and European standards for sustainability reporting closer together. The AFM acknowledges the fact that a global baseline for sustainability reporting will (initially) focus on a narrower range of ESG-topics than the ESRSs, that it follows the principle of single rather than double materiality and that the ISSB will not require corporations to report on impacts *per se* if these do not affect enterprise value creation. However, the AFM holds the strong view that the single materiality lens employed by the ISSB can and should provide room for reporting on many impacts that corporations have on societies and the environment, as we will clarify further on in this letter and in our responses to the survey on ED IFRS S1.

In the AFM's view, the ISSB is well positioned to develop the global baseline for corporate reporting on sustainability matters relating to enterprise value creation. However, to further achieve this goal, we would recommend that the ED IFRS S1 mirrors more closely the long-standing groundbreaking work of the Global Reporting Initiative (GRI) in defining material topics for sustainability reporting. Furthermore, the AFM believes it would be helpful if both EDs incorporate aspects of impact materiality that the GRI has identified which affect enterprise value creation as well. This would benefit reporting entities and investors worldwide who have already made extensive use of GRI standards. Greater alignment with GRI standards would furthermore improve the interoperability with regional European standards for sustainability reporting, because the GRI's work also informs the CSRD's requirements and the ESRSs under development.

Another matter that the AFM sees as particularly important to achieve a high-quality global baseline for sustainability reporting, is the clarity of the standards for all corporate sectors (across national and regional jurisdictions), from the perspective of both the preparers and the users of sustainability-related financial information. With this in mind, we advocate the use of consistent terminology. We also advocate providing clearer definitions of sustainability-related financial information and of the value chain of financial enterprises, as well as relevant sector-specific reporting requirements. We would therefore like to request that the ISSB reviews the consistency of the terminology used throughout the EDs and the set of definitions that it explicitly and implicitly employs.

The AFM's key recommendations regarding both ED IFRS S1 and ED IFRS S2 can be summarized as follows:

A. The notion of 'sustainability-related' financial information

The AFM notes, similarly to ESMA, that ED IFRS S1 does not clearly indicate what the sustainability-related matters are that the standards address. The AFM recommends that the ISSB clarifies what is meant by 'sustainability' and that it selects a scope and definition that converges with GRI standards.

B. Materiality

In line with ESMA, the AFM recommends that "the terminology relating to the identification of risks and opportunities should be clarified and made consistent across the standard (e.g. the use of terms such as 'significant' and 'material')" and that the role of external 'impacts' in assessing enterprise value creation is better clarified and, ideally, made consistent with the impact materiality process of GRI standards. To elaborate on this latter point, the AFM would like to mention that a corporation's negative impacts on societies or the environment can lead to financial losses through for example civil lawsuits, consumer boycotts, exclusion by institutional investors, or future legislation which prohibits certain activities and therefore leads to stranded assets. Negative impacts can also affect enterprise value in subtler ways, such as through reputational effects that damage a corporation's ability to hire talent or diminishes the eagerness of other companies to work with the corporation. Corporations can also degrade their own raw input production base through unsustainable soil or resource exploitation. Conversely, sustainable practices can create value for enterprises through reputational effects, so called 'greeniums', and by making corporations more resilient in the face of changing legislation, social preferences and resource squeezes. A full view of the relationship between sustainability and enterprise value creation therefore goes far beyond *direct* effects of sustainability matters on enterprise value creation (e.g. deteriorating production conditions resulting from climate change) and includes many more indirect effects of the corporation's own impacts on societies or the environment which create (potential) positive or negative feedbacks for the corporation itself.

C. Sector-specific guidance from SASB

The AFM believes that an unselective and mostly unmodified adoption of the SASB framework for sector-specific guidance does not improve the feasibility of the ISSB's proposed standards for reporting entities, nor that it improves interoperability with ESRSs. We therefore would like to repeat ESMA's recommendation "to carefully consider introducing such guidance as part of the mandatory requirements in the climate-reporting standard. We believe that parts of this guidance are not necessarily related only to climate and that they are not yet suitable for application in an international context given their jurisdiction-specific connotation in some cases. In addition, introducing these requirements on a mandatory basis may make convergence with other standard-setting initiatives more difficult than focusing on the sector-agnostic requirements as a first step."

D. Emission compensation (offsets) and aggravation (deforestation)

With regards to the ED on climate-related standards, the AFM is in full agreement with ESMA's recommendation to complement the requirement to disclose 'net' emission targets (after offsets) with a requirement to disclose 'gross' emission targets (before offsets). Not only would this improve interoperability with ESRSs and comparability of European and non-European corporations, in the AFM's view net and gross targets both have their own value for investors and their own separate (potential) consequences for enterprise value creation. Whereas *reforestation* is considered an offset and addressed implicitly by both ED IFRS S2 and ESMA's consultation response, the AFM would also like to make a point concerning negative offsets, in particular *deforestation* (and other damage done to 'carbon sinks'). The AFM recommends 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 proposed European climate-related disclosure requirements similarly exclude matters of deforestation. The AFM will make the same recommendation to EFRAG, as we make in this letter, to include deforestation in climate-related disclosure requirements.

E. Value chains of financial 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 the ISSB considers clarifying 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. For the purposes of sustainability-related disclosures, the relevant value chains of banks, insurance companies, mortgage lenders and other financial undertakings are at present difficult to conceptualize. We are concerned that financial enterprises, due to a lack of guidance provided in IFRS S1 and IFRS S2 on this point, will not on a consistent basis determine their own relevant value chains. The SASB industry specific standards do not adequately address this issue either. Lack of clarity concerning the reporting boundaries for financial enterprises can lead to either underreporting of relevant information or overreporting. The first risk is that financial undertakings do not report significant effects that sustainability-related matters have on their enterprise value creation and value creation potential via the companies they invest in. The second risk is that financial 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. The AFM therefore asks the ISSB to develop an adequate, relevant, bounded and feasible definition of financial-sector value chains.

The AFM's detailed comments on the EDs, following the structure of the consultation surveys, are presented in the Annex to this letter. 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).

Yours sincerely,
The Dutch Authority for the Financial Markets

L.B.J. van Geest
Chair of the Executive Board

H. van Beusekom
Member of the Executive Board

Annex 2: AFM responses to specific questions in ISSB survey 2
ED IFRS S2 Climate-related Disclosures

Question 3 (Identification of climate-related risks and opportunities)
In response to this question, the AFM has two comments based on ESMA's response to the survey about ED IFRS S2.

1. As indicated in our response to Question 4 on the IFRS S1 ED, the AFM believes it would be useful to provide in paragraph 9 examples and guidance on drivers that reporting entities are expected to use to select the relevant time-horizons to make sure that disclosure is comparable amongst different entities.

2. The draft Standard in paragraph 10 says that when identifying significant climate-related risks and opportunities, companies should refer to the disclosure topics defined in the industry disclosure requirements in Appendix B. Mirroring the proposed requirement in paragraph 61 of IFRS S1, it would be useful to add a sentence to clarify that companies should disclose all information which is needed for users to understand their significant climate-related risks and opportunities, regardless of whether the information is mentioned in the appendix.

Question 4 (Concentration of climate-related risks and opportunities in the value chain)
3. The AFM generally supports the proposed requirements relating to value-chain and notes that they appear consistent with those of the draft ESRS (distinction between actual and potential risks and opportunities, description of where in the value chain risks and opportunities are concentrated, qualitative disclosure). However, the AFM calls upon both the ISSB and EFRAG to conceptualize the value chain of financial enterprises material to sustainability reporting and to come to a common understanding of how counterparties (and their value chains) may be incorporated in a consistent manner by financial enterprises in their sustainability reporting. For further elaboration of this point, we refer to our response to the survey on ED IFRS S2 (Question 8).

Question 5 (Transition plans and offsets)
Regarding **Transition plans** the AFM has the following suggestions:

4. In line with ESMA, the AFM notes that while the draft basis for conclusions of the ED refer to specific elements of the transition plans, the actual proposed requirements in paragraph 13 seem not to include some of them, most notably the aspects referred to in paragraph BC73 about the target dates, scope and coverage, as well as the assumptions and uncertainties underlying the plans. While some of these elements are captured in relation to the changes needed to the business model to deliver on the plan (paragraph 13(a)(i)), the AFM suggests introducing the above-mentioned elements in more general terms as key elements of the transition plan disclosures.

5. Given the key role that transition plans play in helping investors understand the trajectory of reporting entities' claimed efforts to reduce their exposure to climate-related risks and their contribution to the

deterioration of the climate system, the AFM believes that transparency around transition plans is key to combat greenwashing. The AFM recommends that in the definition of ’transition plan’ (in Appendix A), the ISSB requires more clearly that the absolute greenhouse gas (GHG) emission reduction actions constitute a minimum requirement of such plans. This is because an entity’s with a plan to reduce its GHG emission intensity only, with no intended GHG emission reduction in absolute terms, should not be able to label its plans as a ’transition’ plan. Another example would be an entity whose plan only includes actions outside of the value chain such as avoided emission targets or offsetting targets and no plan related to emission reduction within the value chain.

6. The AFM suggests requiring disclosure in paragraph 13 of the gross GHG emission reduction target (as well as the net GHG emission reduction target) set in accordance with the transition plan. See also our comment 9 below.

7. In the AFM’s view, plans to reduce deforestation (when deforestation results from the reporting entity’s activities or occurs within its value chain) should be a key element of transition plans. In contrast to *re*forestation, which may be reported as an offset, deforestation is currently not addressed by the ED. We encourage the ISSB to treat not just emissions, but deforestation effects as well, as a metric that should be integral to climate-related transition plans, targets and performance measures. The AFM has noted that the proposed ESRS on climate-related disclosures also excludes deforestation from consideration. The AFM will make the recommendation to consider deforestation as a crucial climate-related factor to EFRAG as well. The AFM encourages both the ISSB and EFRAG to seek similar ways to treat deforestation as a key factor in climate-related disclosures that are material to assessing enterprise value creation.

Offsets:

8. IFRS S2 permits companies to ‘net’ their GHG emissions with offsets to compute their targets, whereas ESRS E1 does not. Netted targets may appear more ambitious than non-netted targets by companies disclosing under ESRS E1. This could be confusing and give an artificially positive impression of companies’ targets under IFRS S2 as compared to under ESRS E1. We would recommend that the ISSB requires reporting entities to report both (gross) emissions reduction targets and (net) GHG neutrality targets.

9. IFRS S2 permits companies to use offsets that are not certified. ESMA notes that offset programmes have been heavily criticised for lacking credibility or integrity (overestimating emissions reductions or removals, double counting, lack of permanence of the emissions reductions or removals, etc.). Certification can help address these problems. Requiring that companies report on offsets which are certified would additionally bring IFRS S2 closer to ESRS E1, especially if IFRS S2 would also require companies to disclose how big a part of their offsets are linked to different certification schemes (paragraph 13(b)(iii)(2)).

Question 6 (Current and anticipated effects)

10. In line with ESMA, we propose the following clarifications to paragraph 14:

a) being more explicit about whether the disclosure required under paragraph 14(a) is expected to be provided simply with cross-references to the financial statements;

b) clarifying what the difference is between the information under 14(b) and the information in the financial statements, for example those required by IAS 1, para 125 (when IFRS are applied by the entity);
c) requiring disclosure on the methodology reporting entities use for computing the anticipated effect under paragraph 14(c) and consider providing application guidance with regards to the possible methodologies; and
d) adding that the information about changes over time in paragraphs 14(c) and 14(d) should distinguish between the short, medium and long term.

Question 7 (Climate resilience)
11. Regarding climate resilience the AFM, following ESMA, has the following suggestions for improvements to paragraph 15:

a) require disclosing information that enables users to understand the resilience of not only their strategy but also their business model (paragraphs 15 and 15(a)(i));
b) amend the definition of climate resilience in Appendix A so that it better aligns with the IPCC definition and focuses on a company's capacity to cope with climate-related hazardous events, trends or disturbances, reorganising in ways that maintain their essential activities and assets. It would also be important to ensure that this definition is converged at international level; and
c) clarify in paragraph 15(b)(i)(3) that it would be useful that scenarios used in scenario analysis could be associated with transition risks and physical risks.

Question 9 (Metrics and GHG emissions)
12. The AFM holds the view that metrics on climate change, whether they relate to targets or performance, need to take deforestation into account. The AFM recommends that the ISSB considers how best to incorporate deforestation-related risks and metrics into its Standards for climate-related disclosures and suggests that the efforts of GRI (in its 2022 Agriculture, Aquaculture and Fishing Sector Standard), TRASE, the Accountability Framework and Engage the Chain (among others) for inspiration in this regard.[2] It is the AFM's view that global consistency in this regard is particularly important, as investors are particularly interested in climate-related risks and performance (in comparison to other sustainability-related topics), so we especially would encourage the ISSB to seek alignment with GRI and EFRAG in this regard.

13. The AFM further notes that the proposed metrics do not address the company's energy consumption and mix of sources (except when assumptions in these areas are included in the climate resilience disclosures). However, specific metrics in these areas are included in the Appendix B for specific sectors (e.g., for Software & IT Services). Such metrics could be considered for inclusion in IFRS S2.

[2] See: https://www.globalreporting.org/standards/standards-development/sector-standard-for-agriculture-aquaculture-and-fishing/; https://supplychains.trase.earth/; https://accountability-framework.org/; https://engagethechain.org/investor-guide-deforestation-and-climate-change.

14. The AFM also suggests requiring more detail on companies' internal carbon pricing, such as critical assumptions used to estimate carbon prices, approximate current year GHG emission volumes covered by the scheme and scope of application of the carbon pricing scheme.

15. In general, the AFM suggests accompanying the required disclosures of metrics in paragraph 21 with implementation guidance to help consistent application of these requirements.

Question 10 (Targets)
16. The AFM notes, in line with ESMA's response, that the proposed disclosure requirements related to targets do not identify the use of pre-defined timeframes. While this is consistent with a principles-based approach, the AFM highlights that the disclosure of GHG emissions targets with largely differing timeframes will undermine comparability and increase the cost of analysing various companies' performance goals across and within sectors.

17. One possible and desirable (from the standpoint of interoperability) approach to anchor the disclosures of targets to common timeframes could be to hint at milestones adopted in other standard-setting initiatives. For example, ESRS E1 requires that GHG emission reduction targets are disclosed 'in five years rolling periods and at least include target values for years 2030 and, if available, for 2050'.

18. The use of common forward-looking reference points will facilitate the consolidation of the targets published by multiple companies for stakeholders such as financial institutions or governments. To support comparability, we would suggest adding wording along the following lines at the end of paragraph 23(g): 'For GHG emission reduction targets, the disclosures shall at least include target values for years 2025 and 2030, and, if available, for 2050. In addition, intermediary targets may be disclosed in five-year periods'.

19. The AFM notes that it would be important to more clearly require in paragraph 23 that reporting entities disclose the progress made towards the pre-set targets and potentially also whether this progress is in line with what they had planned. This goes for the progress made towards net emission reduction targets as well as for the progress made towards gross emission reduction targets (see also our response to Question 5).

20. The AFM would like to emphasize again that the reduction of deforestation effects (damage to carbon sinks) should be seen as an integral part of climate-related targets and that (where this is a material factor for a reporting entity) deforestation reduction targets should be required by the ISSB's Standards on climate-related disclosures. See also our response to Question 5 (Transition plans and offsets) and Question 9 (Metrics and GHG emissions).

Question 11 (Industry-based requirements)
The AFM would like to echo ESMA's answer to this question and make the following points:

21. The AFM refers here to the comments we set out in the response to Question 1 on the IFRS S1 ED. We consider that the extensive body of industry-based standards developed by SASB could help the ISSB to identify some specificities of each sector which should be included in appendices to the relevant topic-specific standards as it is proposed for IFRS S2.

22. The AFM notes that, in some cases, the list of topics addressed in the Appendix B seems to go beyond climate-related matters strictly speaking (e.g., addressing broader environmental and social risks of the entity and its value chains, such as marine resources or even about the level of activity of entities in the different sectors (e.g., when it comes to the number of plants that an entity has).

23. Furthermore, while the IASB has amended the SASB standards, there are still elements that appear more suitable to a North American context than to use elsewhere, including in Europe. For example:

a. Product lifecycle environmental impacts, Metrics CG-AM-410a.2 refers to AHAM (Association of Home Appliance Manufacturers, a North American Association).

b. Metrics CG-BF-130a.1 refers to disclose the total amount of energy it consumed as an aggregate figure in gigajoules (Gj) while in Europe it is common to disclose this measure in MWh.

Question 13 (Verifiability and enforceability)

24. The proposed requirements in the draft IFRS S2 involve a significant degree of judgement and assumptions relating to developments of complex climate-related phenomena and their impacts on reporting entities. Enforcement and auditing challenges may therefore arise, in particular on the use of scenario analysis, the anticipated effects of significant climate-related risks and opportunities on companies' financial position, financial performance and cash flow over a short, medium and long term and certain data requirements for the value chain. The AFM would like to suggest that the ISSB requires reporting entities to report on methodologies used and related assumptions as well as the use of sensitivity analysis.

Question 16 (Global baseline)

25. The AFM's comments in relation to convergence and interoperability with other major standard setting initiatives are set out in our responses to Question 14 in the survey on ED IFRS S1 and we have commented on the interoperability between IFRS S2 and the relevant draft ESRS under Questions 4, 5, 9, 10 and 11.