Finding the opportunity in ESG

ESG disclosures: the bedrock of the sustainable finance agenda

Invesco

Executive summary

To be successful, the development of sustainable finance in Europe needs to be grounded in access to high quality and meaningful ESG disclosures. While the quality and reliability of ESG data has improved considerably, so has the sophistication of investors and their needs for improved ESG disclosure.

Investors find the most value in ESG disclosures when sustainability is embedded in the DNA of the firm as part of their competitive advantage to create long-term value. Companies that create societal value should benefit from changing policy and consumer trends, resulting in more sustainable cash flows, a lower cost of capital and higher valuations. While no standardised reporting framework can ever fully capture and reflect this. Reporting standards should, however, ensure that we move away from boilerplate disclosures and box-ticking approaches to consider the ESG risks and opportunities that are material to each company, industry and sector.

While numerous standards already exist in this space, no single regulatory standard provides a comprehensive framework for companies to disclose in a way that would meet investors' needs. Greater convergence in reporting could fill the gaps in accessing core ESG metrics that investors rely on to develop their ESG screening tools and assessment methodologies. Convergence in ESG reporting standards would also enable such data to be audited, which is becoming increasingly important to investors who base capital allocation decisions on such information.

Beyond these core metrics, we need to connect ESG disclosures with real world outcomes, both adverse impacts as well as opportunities for transition. A holistic approach based on the three pillars of people, planet and prosperity is key to creating true long-term value for all stakeholders.

Introduction

At Invesco, we consider environmental, social and governance issues (ESG) not only as financially material considerations but a core part of long-term value creation. And we are not alone- asset managers and asset owners representing $80 trillion are signatories to the Principles for Responsible Investment (PRI)[1]. Investors are also increasingly interested in using their investments to contribute to environmental and social goals. The Global Sustainable Investment Alliance (GSIA) reported that $444bn was invested in impact funds globally in 2018 (representing an annual increase of 34%), $1 trillion in sustainability themes investments (92% annual growth) and nearly $2 trillion in positive/best-in-class funds (50% annual growth). Access to meaningful and reliable ESG information is therefore an imperative for investors.

ESG reporting has traditionally been referred to as "non-financial", creating a perception that such information is not financially material. Such a notion is outdated and fails to reflect the considerable value investors place on ESG, both in terms of financial risks but also increasingly the significant investment opportunities this presents. We believe that now is the time to retire the term "non-financial" from our lexicon and consider ESG issues as an integral part of company reporting, subject to the same rigour, diligence and auditing.

The EU's review of the Non-Financial Reporting Directive represents an important opportunity to help consolidate the progress made to-date but also to take the next step in ESG reporting: **finding the opportunities, not just the risks, in ESG.**

In its Green Finance Strategy published in 2019, the UK Government set out its expectation for all UK listed companies and large asset owners to disclose in line with the TCFD recommendations and is working with international partners to catalyse market-led action on nature-related disclosures. The role of private finance is also set to be a major pillar of the UK's COP26 agenda. While the UK Government has yet to decide on whether it will adopt the EU's Taxonomy, the UK has committed to match the ambition of the EU's objectives when it comes to sustainable finance.

Reviewing progress: the NFRD to date

What is the NFRD?

The Non-Financial Reporting Directive (NFRD), introduced in 2018, requires large public interest companies[2] to report on ESG matters including environmental protection, social and employee matters, respect for human rights, anti-corruption and bribery and diversity. Companies subject to the Directive must disclose on a comply-or-explain basis, either as part of their management report or in a separate report, on their approach to ESG issues that are likely to impact their financial performance ("outside in" perspective or financially material ESG issues) and how their activities impact ESG issues ("inside out" perspective or ESG impact).

The directive puts the focus on the policies firms have in place to manage ESG risks and the outcome of those policies. The company should explain the principal ESG risks linked to their operations and business relationships and which key performance indicators are used to measure such risks.

The NFRD considers that ESG information is not only of interest to shareholders but also broader stakeholders. Materiality, in the context of the NFRD, therefore includes both the impact of ESG factors on a company's financial performance (hereafter "financially material ESG") as well as the impact of that company's activities on ESG issues (hereafter "ESG impact")- the so-called "double materiality" concept.

When first agreed in 2014, the NFRD represented a significant step forward in terms of ESG reporting. However, as interest in and demand for ESG data has grown rapidly in the intervening period, the NFRD is increasingly seen as out of date.

Recent reviews by regulators such as the European Securities and Markets Authority (ESMA), the French Autorité des Marchés Financiers (AMF) and the Luxembourg Commission de Surveillance du Secteur Finance (CSSF) all identified the lack of comparability across reports and significant gaps in ESG reporting against the NFRD framework. Key issues identified included:

- **Lack of understanding and clarity on the concept of materiality:** The concept of dual materiality is hardly understood. This is enforced by the fact that companies do not routinely disclose any materiality assessment. Hence, some tend to disclose information regardless of materiality ("box ticking").
- **The relationship between financial and non-financial outcomes is often missing:** companies show a lack of consistency between their business strategy, the policies disclosed and the key performance indicator (KPI).
- **Information on qualitative elements are missing or imprecise:** Qualitative assessments including due diligence and human rights were missing or consisted of "boiler plate" disclosures.
- **Tendency to use non-financial reporting as a marketing exercise without external verification:** Companies tend to focus on positive facts while unfavourable aspects omitted 90%. The lack of third-party verification makes it difficult for investors to ensure the completeness and veracity of the information.

These findings underscore what we see as the three fundamental areas that need to be reformed.

Firstly, addressing the "box ticking" nature of the company disclosures and moving away from boilerplate disclosures is paramount for investors. **Meaningful disclosures, with an emphasis on quality over quantity, start and end with materiality.** Therefore, clarifying the concept of materiality is essential, as well as embedding this within the company's overall strategy.

Secondly, the NFRD is also **heavily focused on risks and negative impacts**, with very little focus on ESG opportunities. The introduction of the EU Taxonomy and requirements for companies to report in their revenues, CapEx and OpEx financing Taxonomy-aligned activities will provide a first step in redressing the balance. However, as of today, the EU Taxonomy only covers environmental objectives, whereas social and economic development opportunities are just as important to investors. The Taxonomy, therefore, provides an opportunity for companies to present the very significant opportunities for environmental issues, but social issues are just as important to investors and therefore reporting on social opportunities must be further developed.

Finally, **connecting ESG reporting with real world outcomes.** Reporting on policies and metrics alone are no longer enough for investors to identify the ESG leaders. Such policies and metrics need to be framed around the outcomes and impact they create as a result.

The ESG data ecosystem: international frameworks and standards

A number of existing framework standards exist that companies and investors refer to in developing their internal ESG frameworks. Some of the most widely used include:

- UN Global Compact
- Sustainable Development Goals
- International Integrated Reporting Council
- Sustainability Accounting Standards Board
- Global Reporting Initiative
- CDP Worldwide (formerly Carbon Disclosure Project)
- Taskforce for Climate-related Financial Disclosures

UN Global Compact: the UN Global Compact is a voluntary initiative based on CEO commitments to implement universal sustainability principles and to report on their implementation. The initiative has over 9,500 companies involved across 160 countries.

Sustainable Development Goals: the UN-sponsored Sustainable Development Goals (SDGs)set out a blueprint to achieve a better and more sustainable future. The 17 goals include those related to ending poverty and inequality, mitigating climate change and environmental degradation and promoting peace and justice.

International Integrated Reporting Council: The International Integrated Reporting Council (IIRC) is a global coalition of regulators, investors, companies, standard setters, the accounting profession and NGOs. The coalition is promoting communication about value creation as the next step in the evolution of corporate reporting

Sustainability Accounting Standards Board: The Sustainable Accounting Standards Board (SASB)'s mission is to help businesses around the world identify, manage and report on the sustainability topics that matter most to their investors by developing industry-specific reporting standards

Global Reporting Initiative: The Global Reporting Initiative (GRI) is an international independent standards organization that helps businesses, governments and other organizations understand and communicate their impacts on issues such as climate change, human rights and corruption.

CDP: The CDP is an organisation which supports companies and cities to disclose their environmental impact. It aims to make environmental reporting and risk management a business norm, and drive disclosure, insight and action towards a sustainable economy.

Taskforce for Climate-related Financial Disclosures: The Task Force on Climate-related Financial Disclosures (TCFD) was created by the Financial Stability Board (FSB) to develop voluntary, consistent climate-related financial risk disclosures for use by companies in providing information to investors, lenders, insurers, and other stakeholders.

Each of these consider ESG from different angles. Some of these are broad policy frameworks (for example SDGs) while others are more granular reporting standards (e.g. SASB and GRI) designed to facilitate disclosure and reporting of ESG considerations. Some are broad and cover the breadth of ESG issues (SASB and GRI) while others focus on specific issues such as climate change (TCFD, CDP). Some are focused on financially material ESG issues (SASB) while others focus on ESG impact (GRI).

Despite the different lenses applied to ESG and the differences in approaches, attempts at convergence are already underway. The Corporate Reporting Dialogue (CRD) brings together a number of these standards bodies, who have begun work to converge ESG reporting standards, starting with climate metrics in the context of the TCFD. As part of this work, the CRD found that there is already a high level of alignment between CDP, GRI and SASB with the TCFD illustrative climate metrics: the climate metrics required under the three frameworks were found to be broadly aligned with 70% of the TCFD's 50 metrics.

Alignment with the TCFD illustrative example metrics, and between CDP, GRI and SASB

■ Full ■ Reasonable ■ Moderate ■ Very limited ■ None

No substantive difference Substantive difference

Estimated Scope (Energy) CDP GRI SASB	**Vehicle Sales** (Transportation) CDP GRI SASB	**GHG Emissions** (Materials and Buildings) CDP GRI SASB	**Mechanical Emissions** (Agriculture, Food and Forest Products) CDP GRI SASB	**Fuel Consumption** (Transportation) CDP-SASB CDP GRI SASB
Revenues (Energy) CDP GRI SASB	**EEDI** (Transportation) CDP GRI SASB	**Area of Buildings** (Materials and Buildings) CDP GRI SASB	**Average Carbon** (Financial Services) CDP GRI SASB	**Life Cycle** (Transportation)SASB-CDP CDP GRI SASB
Proportion (Energy) CDP GRI SASB	**Expenditures** (Transportation) CDP GRI SASB	**Reserve Breakdown** (Materials and Buildings) CDP GRI SASB	**Absolute Carbon Emissions** (Financial Services) CDP GRI SASB	**Expenditures** (Materials and Buildings) CDP-GRI, CDP-SASB, SASB-CDP CDP GRI SASB
Gross Amount (Energy) CDP GRI SASB	**Road Vehicles** (Transportation) CDP GRI SASB	**Percentage Certified** (Materials and Buildings) CDP GRI SASB	**Portfolio Carbon Emissions** (Financial Services) CDP GRI SASB	**Energy Intensity** (Materials and Buildings) CDP-GRI, CDP-SASB, SASB-CDP CDP GRI SASB
Indicative Costs (Energy) CDP GRI SASB	**Investment** (Transportation) CDP GRI SASB	**Revenues** (Agriculture, Food and Forest Products) CDP GRI SASB	**Volume of Portfolio Carbon** (Financial Services) CDP GRI SASB	**Fresh Water Percentage** (Materials and Buildings) CDP-SASB, SASB-CDP CDP GRI SASB
Assets (Energy) CDP GRI SASB	**Revenues** (Materials and Buildings) CDP GRI SASB	**Water Withdrawn** (Agriculture, Food and Forest Products) CDP GRI SASB	**GHG Emissions** (All) CDP-SASB, GRI-SASB, SASB-CDP, SASB-GRI CDP GRI SASB	**Investment** (Materials and Buildings) CDP-GRI, CDP-SASB, SASB-CDP CDP GRI SASB
Reserves Breakdown (Energy) CDP GRI SASB	**Energy Consumption** (Materials and Buildings) CDP GRI SASB	**Water Percentage** (Agriculture, Food and Forest Products) CDP GRI SASB	**Carbon Prices** (Energy) SASB-CDP CDP GRI SASB	**Expenditures** (Agriculture, Food and Forest Products)CDP-GRI, GRI-CDP CDP GRI SASB
Capital Payback (Energy) CDP GRI SASB	**Fuel Consumption** (Materials and Buildings) CDP GRI SASB	**Assets** (Agriculture, Food and Forest Products) CDP GRI SASB	**Expenditure Low Carbon** (Energy) CDP-SASB, SASB-CDP CDP GRI SASB	**Purchased Energy** (Agriculture, Food and Forest Products)CDP-SASB, SASB-CDP, SASB-GRI CDP GRI SASB
Average Fleet Fuel (Transportation) CDP GRI SASB	**Building** (Materials and Buildings) CDP GRI SASB	**Non-mechanical Emissions** (Agriculture, Food and Forest Products) CDP GRI SASB	**Percentage of Water** (Energy) CDP-SASB, SASB-CDP CDP GRI SASB	**Investment** (Agriculture, Food and Forest Products) CDP-GRI, GRI-CDP CDP GRI SASB
Revenues (Transportation) CDP GRI SASB	**Water Intensity** (Materials and Buildings) CDP GRI SASB	**Land Use** (Agriculture, Food and Forest Products CDP GRI SASB	**Investments** (Energy) SASB-CDP CDP GRI SASB	**Percentage Carbon** (Financial Services) SASB-CDP CDP GRI SASB

Source: Corporate Reporting Dialogue, Driving Alignment in Climate-related Reporting, September 2019.
For each of the 50 TCFD illustrative example metrics, the figure shows the level of alignment (i.e. full, reasonable, moderate, very limited or no alignment) with the relevant indicator(s) of each of the three participants, as indicated by the colouring of the CDP, GRI and SASB boxes.
The figure also shows the level of alignment between the three participants' relevant indicators. Where there is substantive difference it is shaded pink and the nature of that difference is indicated, i.e. SASB-CDP denotes that information collected by the SASB indicator is not applicable for reporting with CDP's framework.
The name of each of the 50 TCFD illustrative example metrics is given in bold with the applicable sectors indicated in brackets.

The CRD found that perceptions of market participants regarding the level of consistency between different frameworks is very low, which belies the level of convergence they found in their in-depth analysis.

To test this idea further, we undertook a high-level comparison of the core ESG issues covered by SASB and GRI (see Annex) and found that, at a high level, there is significant convergence in terms of environmental issues covered by both frameworks. The key obstacle to greater convergence lies in the different methodologies for the underlying environmental metrics as well as in terms of which issues are considered material for each sector.

Convergence of social issues, however, was much lower. Our findings are reflected in conversations with investee companies, who report that environmental reporting is more straightforward as there is greater commonality in the issues that matter to investors, whereas there are greater differences of view as to which social issues matter.

This reflects the findings set out above regarding the need for greater clarity with regards to materiality. The **SASB materiality map** **has been found to be a useful tool** in order for companies and investors to come to a common view as to what is financially material. This approach could be expanded beyond financially material ESG issues to also include ESG impacts by sector.

While no single approach provides a comprehensive framework for both companies, investors and broader stakeholders to use and full convergence continues to be some way off, we believe that the revised Non-Financial Reporting Directive should seek to build on the core elements of these existing frameworks to define a comprehensive and integrated reporting framework. In our view the central elements of such a framework are:

Integrated reporting:

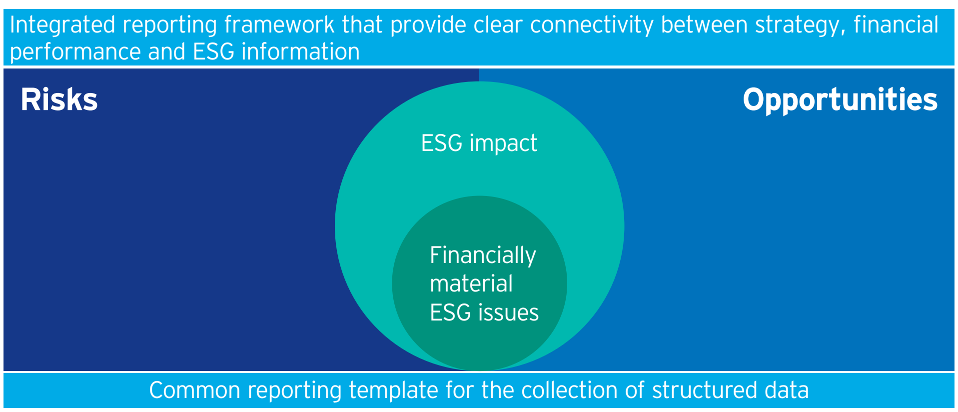
Integrated reporting is essential to demonstrate how ESG has been embedded within the business, rather than merely an adjunct to the business. The TCFD, which emphasises connectivity between the different pillars of reporting-governance, strategy, risk management and metrics-and with financial performance presents a model that has gained widespread traction amongst companies and investors and could be expanded beyond climate-related reporting.

Defined standards:

To provide greater consistency of reporting and **mitigate any self-selection bias**, reporting companies to identify the core issues that are likely to be material to their industry, building on the SASB materiality map, and set out common reporting metrics to report against these issues. Such a standard should assist companies in defining the universe of relevant ESG risks and opportunities, both those where they may have an impact, as well as the smaller universe of those issues that are financially material.

Structured reporting:

A structured reporting questionnaire and KPIs, such as CDP, that gives investors access to structured and aggregated data sets on which to build models and screening tools. Structure reporting should also include an overview of the company's targets, busiiness impact assessment and products.



The ESG data ecosystem: the role of ESG ratings and data providers

Third-party services providers have increasingly been used by investors to bridge the gap between investors needs for comparable ESG disclosures and the data currently available from companies. Providers, such as MSCI, Sustainalytics and Vigeo Eiris, provide ESG ratings are well as access to underlying ESG data for investors to use in their investment processes.

While such ratings and data are invaluable for investors to assist in assessing thousands of companies and provide an aggregate ESG score that are normalised across sectors, the issue of comparability remains.

A recent MIT paper found that the correlation between the five major ESG providers was 0.61[3]. For comparison, the correlation between the main three credit rating agencies is 0.99. The two key drivers of divergence related to differences in concepts of materiality, i.e. different rating providers focus on different issues, and differences in weightings, i.e. the degree of importance assigned to each issue. Some level of divergence is natural and indeed desirable for investors who may have different investment preferences.

However, the lack of reliable information from companies also contributes to this divergence, since it means that ESG providers need to fill the gaps by other means, for example through modelled data. To assess the extent to which these models differ, we compared the carbon data of two major providers and found a correlation of 0.98. However, when the data is based on modelled data rather than reported data, the correlation reduces to 0.67. When based on reported data, the correlation is 0.99.[4] This underscores the importance of reported data from companies in order to drive convergence.

Another starker example of divergence relates to the assessment of "significant harm" or "adverse impact". The UN Global Compact has come to be used as the defining framework to screen companies that fail to meet minimum environmental, social and human rights standards and investors rely on third party data providers to screen for such ESG controversies. We analysed the UN Global Compact screens for three major EGS providers[5]. The number of companies flagged as non-compliant by each provider ranges from 9 to 166. When companies on the watchlist are included, the universe of companies flagged ranges from 31 to 509. Our analysis found that no company was flagged as non-compliant by all three providers. If we expand this to include companies that are flagged as either non-compliant or on the watchlist, only three companies are common to all three providers (out of a combined universe of 550 companies flagged on at least one list).

While we believe that a certain level of diversity in the market is welcome and reflects the dynamism in the ESG world, such a high level of divergence in scores can lead to confusion for both investors and companies as to what issues really matter. More specifically, it complicates the enforcement of ESG labelling standards for financial products where elements such as the exclusion of UN Global Compact violators are cornerstone commitments.

Beyond the lack of comparability, another important consideration is that such providers are often screening thousands of companies based on certain indicators and then benchmarks companies against peers. Such an approach can lead to boilerplate disclosures from companies to tick all the boxes to get a higher score, while ignoring the specificities of the companies' business models that deliver significant ESG impact alongside financial performance through competitive advantage. Therefore, while such scores can provide an initial screen for investors, for fundamental active investors, it can never be a substitute for in-depth fundamental company research and analysis and active dialogue with companies.

Ensuring transparency around ESG rating providers' methodologies is important so that investors can understand the inputs and assumptions made and understand what is being measured. Consistent with our belief that ESG needs to be embedded within the financial reporting by companies, we would like to see ESG issues being embedded in sell-side research as part of their financial analysis, rather than a siloed activity that is divorced from the fundamentals of the business in question.

An investor view of ESG disclosures

Investor demands for ESG disclosures are becoming increasingly sophisticated as the level of adoption of ESG integration and ESG investing grows. Advocating for greater transparency by companies in relation to ESG matters is a major focus of our engagement with investee companies, as well as through proxy voting where relevant.

Regulatory demands on investors and other financial intermediaries in relation to ESG are also increasing (including the new EU Sustainable Disclosures Regulation, EU Taxonomy and Climate Benchmarks Regulation), access to reliable and high-quality ESG disclosures from companies becomes an imperative.

The EU **Sustainable Disclosures Regulation** (SFDR) introduces disclosure obligations on how institutional investors and asset managers integrate environmental, social and governance (ESG) factors into their risk management processes. Delegated acts will further specify requirements on integrating ESG factors into investment decisions, which is part of institutional investors' and asset managers' duties towards investors and beneficiaries.

The **EU Taxonomy** establishes the conditions and the framework to gradually create a unified classification system ('taxonomy') on what can be considered an environmentally sustainable economic activity. This is a first and essential step in the efforts to channel investments into sustainable activities. Financial intermediaries providing environmentally sustainable products must disclose how their products align with the Taxonomy, and companies subject to the NFRD must also report the proportion of revenues, CapEx and/or Opex derived from Taxonomy-aligned activities.

The **EU Climate Benchmarks Regulation** creates a new category of benchmarks comprising climate transition and Paris-aligned benchmarks, which will provide investors with better information on the carbon footprint of their investments. It also mandated benchmark providers to enhance transparency concerning the ESG performance of their benchmarks and the methodologies underpinning ESG benchmarks they provide.

Core ESG metrics

While the approach to ESG will vary depending on the investment style and strategy of the asset manager, access to core ESG metrics either as part of screening tools or to develop their own models is often the starting point. At Invesco, our investment teams are increasingly developing their own proprietary ESG assessment methodologies, which requires access to structured ESG metrics. However, access to key metrics across the broad range of asset classes and geographies in which our teams invest remains complex.

The availability and quality of ESG information is improving but it remains challenging for investors to make use of this data in a streamlined way and to compare it across companies and portfolios.

Sample ESG metrics and their availability

Disclosure Factors	Equities (MSCI World Index)	Fixed Income – Corporates (Bloomberg Barclays Global Aggregate Corporate Index)
UNGC Violations	Data available on 99.39% (by count)	Data available on 70% (by count)
Carbon intensity	96% (by index weight)	42% (by bond count)
Fossil Fuel Sector Exposure	5.31% (by index weight)	Yes, 3% of the bonds (by count)
Green Bonds	N/A	No universal standard
Exposure Climate-Related Physical Risks	96% (by index weight)	42% of the bonds (by count)
Exposure Climate-Related Physical Risks Methodology	96% (by index weight)	42% of the bonds (by count)
Social Violations	UNGC data available on 99.39% (by count)	UNGC data available on 84% (by count)
Controversial Weapons	100%	100% of the MSCI World Index (many of the companies are also bond issuers)
Tobacco	100%	MSCI ESG Research covers 100% of the MSCI World Index (many of the companies are also bond issuers)
Board Independence %	99.71% (by index weight)	43% (by bond count)
Board Diversity %	99.71% (by index weight)	43% (by bond count)

Source: Invesco, based on data from Sustainalytics and ISS Climate Solutions.
Note: the indicators are a snapshot of data available as at July 2019. The choice of indicators was derived from the European Commission's Technical Expert Group draft report on ESG disclosures for benchmark providers.

Quantitative metrics, particularly for environmental factors such as greenhouse gas (GHG) emissions, energy use and water use but also some social issues such as diversity and employee turnover, are widely available. However, the methodologies for the calculation of data are not always clear or aligned with investor needs. For example, the Febelfin label sets annual thresholds for carbon intensity in electricity generation, which declines each year. However, while the standard outlines a current year budget, the data available to investors is often available with a lag of one year or more.

However, the most significant gaps relate to qualitative metrics relating to human rights policies, data privacy policies, etc., which are the most challenging and where we continue to rely on third party providers. However, as our analysis set out above shows, the variance between research providers is significant and therefore it is very difficult to assess this information on a consistent basis.

Beyond these standard metrics, investors are increasingly calling for companies to report more advanced metrics. For example, in relation to climate change, in addition to reporting on GHG emissions, we would like to see companies for whom climate change is a material risk also report on the following:

- Amount of investment in new carbon reduction/ environmental sustainability technologies (CAPEX; R&D spend)
- Details on how targets are set and plans of how to reach them (e.g. use of Science based targets)
- Current assessment and scenario analysis for climate-related transition and physical risks, including any internal carbon price

To make sense of the KPIs, it's important for our investors to understand the methodologies that have been used and to ensure that the methodologies are consistent over time in order to identify trends in the data. We would like to see a move towards more structure reporting that goes beyond high-level narrative to include forward-looking information and more standardised metrics.

Assessing ESG outcomes

Beyond accessing the core metrics, investors increasingly want to understand how this information connects with real world outcomes. All too often, ESG outcomes are not reported or are muddled in as part of a broader Corporate Social Responsibility report, which conflates philanthropy with the ESG impact of the company's core business. However, investors increasingly want to understand how companies are embedding sustainability into their business model and using it to create long-term value as well as positive outcomes for society.

First, do no harm: defining adverse impact

Historically, the concept of impact under NFRD but also, for example in socially responsible investing, has been focused on avoiding harm, and therefore investors have focused on the screening for and exclusion of companies linked to ESG controversies or industries that are deemed to be harmful, such as tobacco or coal. Indeed, when one looks at the 33 core issues include in GRI, the vast majority are focused on the concept of harm, with very little focus given to positive ESG impacts.

While applying exclusions to specific sectors such as tobacco and coal is largely straightforward, such screens are normally applied on the basis of a revenue threshold. For example, the Febelfin label sets the threshold for the exclusion of tobacco companies at 10% of revenues. Therefore, it does require companies to provide clear reporting about the percentage of revenues that are derived from each business line.

However, investors are increasingly moving away from divestment and exclusions towards engagement with investee companies to advocate for change. Assessing adverse impact in relation to specific themes, such as human rights, anti-corruption and bribery and environmental degradation remains more challenging. As our analysis above shows, information on policies and outcomes is often lacking and there is no agreed methodology for assessing when a company may have had significant adverse impact on an ESG factor. There is also no consistent view on which adverse impacts are material to which sectors.

Adverse impact is also a core principle of many of the new EU sustainable finance regulations. Financial services firms with more than 500 employees will be required to report on the adverse impacts of their investments, while the definition of environmental sustainability under the Taxonomy also includes the requirement to "do no significant harm" and to meet minimum social safeguards. While the Technical Expert Group has developed detailed "do no significant harm" criteria for each economic activity, the criteria set out have their limitations. Firstly, the criteria currently only cover environmental objectives. Secondly, the criteria apply at the economic activity or asset level and therefore it is difficult to scale them up to the corporate or portfolio level.

Developing a meaningful and consistent definition of adverse impact or a "brown taxonomy" could therefore assist both companies and investors in assessing negative ESG outcomes and taking steps to minimise and mitigate such harm. The development of an ESG impact materiality map could help companies and investors alike better identify which adverse impacts are likely to be material by industry and geography.

Then try to prevent it: Identifying ESG opportunities

Demonstrating the positive impact that can be generated through our investments is increasingly coming to the fore. While impact investing has traditionally been conflated with philanthropy, understanding how businesses are harnessing the opportunities presented by the transition towards a more sustainable economy to create value for shareholders and wider society goes to the very heart of ESG investing. **True value is created when people, planet and prosperity go hand in hand.**

Thematic funds linked to ESG themes, in particular the Sustainable Development Goals, are growing rapidly. However, the SDGs were conceived as a policy framework for governments rather than as an investment tool, which can make it difficult for companies and investors to translate into a reporting and investment framework. Furthermore, ESG impact reporting has historically focused on ESG metrics that are hard to relate to financial value of the company.

The EU Taxonomy represents an innovation in this field as it not only sets out a clear framework that is conceived for the purposes of investment but also seeks to measure ESG impact in relation to financial value (in terms of revenues, CapEx and/or Opex). It also considers not only the company's operations but also the impact of the products and services it produces. This is critical for investors to increasingly see ESG as an opportunity rather than a cost. Materiality remains key: the Technical Expert Group (TEG) on Sustainable Finance, by focusing on 7 macro sectors, has in essence created a materiality map for climate change and this could be expanded for the other four environmental objectives under the Taxonomy.

At Invesco, we believe that the most exciting ESG opportunities lie not in those sectors that are already sustainable but in transitioning "brown" sectors to more sustainable business models. To us, this is the true definition of "impact". **The EU Taxonomy, therefore, needs to become the tool of the transition.** Simply reporting a headline percentage of revenues is not the objective but rather, the Taxonomy should be used as a framework for companies to set out how they plan to move towards greater Taxonomy-alignment over time. **Taken together with a coherent definition of adverse impact, it creates the framework to map "from" and "to" for both companies and investors to mobilise around transition.**

The EU Taxonomy remains a work in progress and, as part of the next phase of development, we believe there are significant opportunities to further enhance the Taxonomy to make it the tool of transition, as well as improving its usability.

1 Tool for transition

The definition of transition under the Taxonomy should be broadened to encourage all companies across all sectors to transition to more sustainable business models. This could be based on sectoral transition pathways, such as those developed by the Science-based Targets Initiative and the Transition Pathway Initiative.

2 Improving consideration of lifecycle effects

By focusing on Nomenclature des Activités Économiques dans la Communauté Européenne (NACE) codes, the Taxonomy breaks down value chains into their component parts, which, while operationally simpler, limits the ability to consider the upstream and downstream contributions sectors can make. For example, the TEG itself highlighted that the biomass sector is focused exclusively on the emissions produced to produce energy but fails to consider whether then inputs are themselves coming from sustainable sources.

3 Complementing proportion of revenues with absolute figures

By focusing on reporting on percentages of revenues, CapEx and OpEx, it may mask the true impact of their activities. For example, company A is a large conglomerate with a subsidiary that is a leader in a a Taxonomy-aligned activity accounting for $10bn in revenues but only 5% of total revenues of the combined group. Company B, on the other hand, is a small niche player in green technology with $500m of turnover, all of which is aligned to the Taxonomy. On paper, company B has the higher Taxonomy-aligned revenues but it is clear that in practice, company A's business is likely to be creating more impact since its total revenues from Taxonomy-aligned activities in 20x higher than company B. This dilution effect of reporting as a percentage of revenues can therefore mask the true impact, both positive and negative, that companies have. Complementing percentages with absolute figures for turnover, CapEx and OpEx could therefore help investors make more informed choices.

4 Making the EU Taxonomy internationally relevant

The design of the EU Taxonomy is embedded in EU laws and systems, including the design of many of the technical screening criteria and many of the Do No Significant Harm criteria. This is likely to limit the international relevance of the EU Taxonomy outside Europe, which is an objective of the EU's Sustainable Finance Strategy. Part of the challenge is that the Taxonomy sets out very high-level principles in the primary law but then jumps straight into very specific technical screening criteria. However, many of the technical screening criteria are themselves based on certain key principles, which could be drawn out. For example, while the transition thresholds for manufacturing are linked to the EU Emission Trading Scheme (ETS), and therefore are unlikely to be relevant outside the EU, they are based on the principle that significant contribution is defined as the top 10% of installations. By drawing out these core principles in how the more detailed technical screening criteria are to be developed, it would allow other jurisdictions to follow the same principles but define thresholds that are relevant to their market.

The EU Taxonomy, however, is only the first part in creating a holistic framework to measure the value companies create across the three pillars of people, planet and prosperity. It is only by progressing across all three dimensions, recognising the interlinkages and interdependencies between the three pillars, that investors can identify the truly leading sustainable companies. **Developing a Social Taxonomy, linked to the SDGs, that would enable investors and companies to identify and value the way they treat their stakeholders- employees, suppliers, customers and communities- is the logical next step.**

Putting the jigsaw pieces together

Meaningful ESG disclosure is so much more than a reporting standard, but it's a good place to start.

In moving towards a more comprehensive and streamlined reporting and disclosure framework, we believe that a future framework should seek to leverage the best elements of existing frameworks and standards and seek to bring them together into a more cohesive whole.

We would advocate that such a standard should be based on the following four pillars:

- Integrated reporting framework that embeds sustainability at the heart of the business;
- Reporting standards that are internationally consistent, with clearly articulated and industry-specific definition of double materiality at their core and that encompass risks and opportunities;
- Structured and forward-looking ESG metrics and targets based on standard calculation methodologies;
- Reporting framework underpinned by rigorous assurance of the ESG data.

Delivering better quality and reliable core ESG metrics would already be a huge achievement but it remains the first step. Further work is still needed to come to a common definition of "do no harm" as well as map the landscape of ESG opportunities for people, planet and prosperity. Taken together, they provide the framework for business and investors to measure impact and long-term value creation.

1 Source: PRI, as at end 2019

2 Defined as listed companies with more than 500 employees

3 https://mitsloan.mit.edu/ideas-made-to-matter/why-esg-ratings-vary-so-widely-and-what-you-can-do-about-it. Study was based on data from 2014 (with a rerun in 2017 as one major data provider has disappeared from the market in between but the findings remained the same)

4 Source: Invesco as at reporting year 2017.

5 UN Global Compact screens as at July 2019

GRI- Environmental

High alignment | Medium alignment | Low alignment

		Emissions	Energy	Water &effluents	Waste & effluents	Biodiversity	Materials	Environmental compliance	Supplier environmental assessment
SASB- Environment	GHG emissions	High							
	Air quality	High							
	Energy management		High						
	Water management			High					
	Waste management				High				
	Ecological impacts					High			

GRI- Social

		Employment	Labour/Management relations	Health & safety	Training & education	Diversity & equal opportunity	Non-discrimination	Freedom of association & collective bargaining	Child labour	Forced labour	Security	Rights of indigenous peoples	Human rights	Local communities	Supplier social	Customer health and safety	Marketing & labelling	Privacy	Public policy	Socio-economic compliance
SASB- Social and human capital	Human rights & community relations										Low	Medium	Medium	Medium						Low
	Customer privacy																	High		
	Data security																	High		
	Access & affordability																			
	Product quality & safety															High				
	Customer welfare															Low				
	Selling practices & labelling																High			
	Labour practices		Low					Low	High	High										
	Employee health & safety			High																
	Employee engagement, diversity & inclusion	Low			High	Low	High													

GRI: Economic

		Procurement	Anti-corruption	Anti-competitive behaviour	Market presence	Economic performance	Indirect economic impact
SASB- Business Model & innovation; Leadership and governance	Product design & lifecycle management						
	Business model resilience					Medium	Medium
	Supply chain management						
	Materials Sourcing and efficiency						
	Physical impacts of climate change					Medium	
	Business ethics		High				
	Competitive behaviour			High			
	Legal and regulatory risk management					Low	
	Critical incident risk management						
	Systemic risk management						

SASB Materiality Map®

SASB's Materiality Map® identifies sustainability issues that are likely to affect the financial condition or operating performance of companies within an industry. In the left-hand column, SASB identifies 26 sustainability-related business issues, or General Issue Categories, which encompass a range of Disclosure Topics and their associated Accounting Metrics that vary by industry. For example, the General Issue Category of Customer Welfare encompasses both the Health and Nutrition topic in the Processed Foods industry and the Counterfeit Drugs topic in the Health Care Distributors industry. For commercial use terms of the SASB Materiality Map®, please contact us.

The SASB Materiality Map® does not contain all guidance necessary for use of the standards. To download the SASB standards, click here.

マテリアリティマップの日本語版をご覧になるには、ここをクリックしてください To see a version of the Materiality Map in Japanese, please click here.

Sector Level Map

- Issue is likely to be material for more than 50% of industries in sector
- Issue is likely to be material for fewer than 50% of industries in sector
- Issue is not likely to be material for any of the industries in sector

Industry Level Map

- Not likely a material issue for companies in the industry
- Likely a material issue for companies in the industry

		Consumer Goods	Extractives & Minerals Processing	Financials	Food & Beverage	Health Care	Infrastructure	Renewable Resources & Alternative Energy	Resource Transformation	Services	Technology & Communications	Transportation
Dimension	General Issue Category	Click to expand	Click to expand	Click to expand	Click to expand	Click to expand	Click to expand	Click to expand	Click to expand	Click to expand	Click to expand	Click to expand
Environment	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											
	Access & Affordability											
	Product Quality & Safety											
	Customer Welfare											
	Selling Practices & Product Labeling											
Human Capital	Labor Practices											
	Employee Health & Safety											
	Employee Engagement, Diversity & Inclusion											
Business Model & Innovation	Product Design & Lifecycle Management											
	Business Model Resilience											
	Supply Chain Management											
	Materials Sourcing & Efficiency											
	Physical Impacts of Climate Change											
Leadership & Governance	Business Ethics											
	Competitive Behavior											
	Management of the Legal & Regulatory Environment											
	Critical Incident Risk Management											
	Systemic Risk Management											

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