UNDERSTANDING IMPACT MATERIALITY: ESRS REPORTING FOR FINANCIAL INSTITUTIONS

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This publication draws on Shift's involvement in drafting the European Sustainability Reporting Standards, our expertise in the UNGPs, and our advisory work and research on banks' approach to double materiality assessments (DMA). Although this publication refers to banks, the content also applies to other financial institutions who are likely to be connected to severe impacts via their portfolio companies, such as asset managers, asset owners and insurance companies.

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1. INTRODUCTION

Financial institutions and other companies are currently preparing their first reports under the EU's Corporate Sustainability Reporting Directive (CSRD), based on the European Sustainability Reporting Standards (ESRS). Many banks, however, appear to be incorrectly interpreting and applying the requirements in the ESRS on impact materiality. These misinterpretations would severely undermine the double materiality assessment (DMA), which is the cornerstone of sustainability reporting. The result of flawed DMAs is that banks will fail to report on material human rights impacts that they are involved with via their client relationships.

Human rights reporting plays a key role in supporting and incentivizing businesses to respect human rights. Done right, it can yield vital insights into whether and how businesses understand and address their most critical impacts on people and equip investors and other stakeholders to hold business accountable. The ESRS are designed to ensure that companies report on their sustainability performance across environmental (including climate), social (primarily human rights) and governance issues in ways that are rigorous, comparable and meaningful. Critically, they are deliberately aligned with the international standards on corporate respect for human rights (the UNGPs and the OECD Guidelines), which have demonstrated over a decade of practice how companies, including financial institutions, can effectively identify and address risks to people in their operations and value chains.

Key to reporting under the CSRD is the concept of double materiality, which requires companies to look at material impacts on people and the environment ("impact materiality") in addition to financially material risks and opportunities associated with each. This means all reporting companies are required to consider impacts "connected with the undertaking's own operations and upstream and downstream value chain, including through its products and services, as well as through its business relationships."[1]

With their large portfolios, financial institutions are connected to an especially large number of actual and potential impacts through clients and their own value chains, often in all sectors of the economy. Whilst banks may have legitimate questions about the interpretation and application of the ESRS, they can avoid pitfalls by looking at the international standards on which they are deliberately based.[2] This is particularly relevant to banks that have situated ownership of implementation of the ESRS with teams that have not been exposed to the UNGPs and OECD Guidelines.

1 ESRS 1, para. 43. See also ESRS 1, Section 5.1 Reporting Undertaking and Value Chain, para. 63.

2 ESRS 1, para. 45: "The ***materiality*** assessment of a negative impact is informed by the due diligence process defined in the international instruments of the UN Guiding Principles on Business and Human Rights and the OECD Guidelines for Multinational Enterprises. See also ESRS 1, para. 60.

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2. IMPACT MATERIALITY ASSESSMENTS SHOULD MIRROR SALIENCE ASSESSMENTS

Banks must assess the severity of the negative human rights impacts are that they are involved with. This is based on three factors:

- **Scale**: the gravity of an impact
- **Scope**: the number of individuals that are or could be affected
- **Irremediability**: how difficult it would be to restore people's prior enjoyment of the rights

In the case of potential negative impacts, banks must also consider their **likelihood of occurrence.** This process of assessing severity and likelihood is the same as the prioritization process in the international due diligence standards, which is typically referred to as 'salience' instead of 'materiality'. Over the past decade, many banks have conducted salience assessments. Except for the introduction of the term 'impact materiality', nothing has changed. It is thus expected that banks' assessment of impact materiality will mirror the impacts featured in their previous salience assessments. Downplaying or failing to consider previously identified impacts should raise red flags with internal audit and external assurance providers.

Double Materiality refers to the principle that companies need to consider:

- Impacts (negative and positive) on people and the environment, for example the occurrence of child labor in a company's value chain, and
- Financial risks and opportunities stemming from environmental and human rights matters, such as the financial implications of strikes.

When a company concludes that a particular sustainability matter is indeed material, this triggers the more detailed reporting requirements under the ESRS.

The social topics of the ESRS that companies may deem material are categorized in terms of the groups of stakeholders that can be affected:

S1: Own workforce

S2: Workers in the value chain

S3: Affected communities

S4: Consumers and end-users

The ESRS provide for reporting on sub- or sub-sub-topics in relation to each group of stakeholders. For example, material impacts may relate to forced labor among supply chain workers, discrimination against employees, impacts on the land-related rights of Indigenous Peoples, or health impacts on consumers or end-users or products and services.

Banks, as with other organizations with a large range of potential connections to impacts, have commenced salience assessments with a general risk-based overview, before then working out where to go deeper with the due diligence. Even if banks have not previously completed a salience assessment, practice shows that they are well-aware that their most severe impacts are typically those that they are connected to via their client relationships. It is of note that EFRAG itself has issued guidance clarifying that financial assets are business relationships, providing the example of connection to impacts via a loan agreement.[3]

3 EFRAG IG2, Value Chain Implementation Guidance (May 2024) paras 100-101

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3. SALIENCE (SCALE, SCOPE, IRREMEDIABILITY) AND LIKELIHOOD ARE THE ONLY RELEVANT FACTORS

Banks should keep to the accepted process for determining impact materiality, and not introduce irrelevant factors such as the 'proximity' of impacts to the bank. Impacts that banks cause or contribute to through their own activities, such as allowing a gender-pay gap in the workforce or discrimination against retail clients, are not given additional weight in the impact materiality assessment simply because they are more proximate or easier to control. Rather, they should be assessed on the same criteria as impacts that they are involved with via their clients, such as curbs on freedom of association or land grabbing. Where they meet an equivalent or greater level of severity and likelihood, they should be included as material; but the test is the same.

Similarly, there is no automatic hierarchy between impacts in clients' own operations and impacts in clients' value chains, as the ESRS are clear that the DMA should consider impacts that companies are connected to through **indirect business relationships.** For example, if a bank finances textiles companies, they may – depending on the type of financial relationship - also be exposed to impacts via the suppliers of those companies, such as child labor in the production of their goods.

This does not mean that banks are always connected to every impact in their clients' operations or value chains. The international due diligence standards do make clear that there are limits– e.g. in the case of project finance, the bank will not be linked to impacts occurring elsewhere in that client's operations or value chain, outside the scope of the funded project. Any assumptions or methodologies regarding 'the limits of linkage' should be consistent with the UNGPs and OECD Guidelines. Future sector-specific standards for the financial sector may also clarify such limits.

Banks should thus aim to identify all types of impacts that they are (potentially) connected to, whether that's a gender-pay gap in its own work force or forced labor in its clients' operations, and assess impact materiality based on their relative scale, scope and irremediability. Consideration of other factors such as proximity, operational control or degree of leverage is not relevant to the assessment.

4. BANKS MUST LOOK ACROSS THEIR FULL PORTFOLIO FOR IMPACTS ON WORKERS AND COMMUNITIES IN THE VALUE CHAIN

Some banks appear to be assuming that there will be no material issues for them to report under S2, on workers in the value chain, and S3, on affected communities. Banks may be arriving at this conclusion due to a misunderstanding about the relevance of lending exposure to the DMA.

The volume of exposure, in monetary terms, is relevant to assessing financially

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material risks. However, as noted above, in the case of impact materiality, the operable question is the severity and likelihood of the impacts. As we also note above, assessing severity includes an assessment of the scope of impacts; that is, how widespread they are. To assess this the bank will need to look across all of its portfolio companies. Severity also includes an assessment of scale, that is, the gravity of the impact. The ESRS are clear that impacts that meet the threshold of materiality may even arise at the level of an individual site or asset. By analogy, impacts may already be material when they occur in a part of the bank's portfolio or even at the level of an individual client relationship, for example when that client may be complicit in the most severe violations of international human rights or humanitarian law.

Internal audit and external assurance providers would be well advised to be on the lookout for the inappropriate overweighting of exposure in the assessment of severity of impacts, and ask critical questions of any banks omitting impacts relating to Workers in the value chain (S2) or Affected Communities (S3).

5. BANKS MUST LOOK BEYOND READILY-AVAILBLE QUANTITATIVE DATA TO ENSURE SOUND MATERIALITY ANALYSIS

Banks increasingly collect sustainability-related information from their clients, both directly and via external service providers. However, the sheer volume of client relationships and the possible connection to impacts via clients' value chains means that data availability and quality will generally be low. This contrasts with the data that banks have on impacts they are connected to via their own operations. The ESRS recognize that the extent and quality of data that is available will vary but should not prevent a sound materiality analysis. Indeed, it recognizes that "the use of reasonable assumptions and estimates, including scenario or sensitivity analysis, ... an essential part of preparing sustainability-related information".[4]

Furthermore, there are risks in taking excessively 'data-driven' approaches to the DMA. The fact that the DMA seeks to capture not only impacts that have already manifested, but also potential impacts that could materialize on a long-term time horizon of >5 years clearly signals the need for assumptions and estimates. In addition, evaluating purely quantitative information at the level of portfolios or sectors risks obfuscating certain material impacts. For example - the abuses of Indigenous Peoples' rights in connection with the construction of the Dakota Access Pipeline in the United States, which turned out to be both a material impact and a financial risk for various banks involved, are unlikely to have been surfaced through data-driven portfolio analyses. Portfolio analyses will thus need to be supplemented

4 ESRS 1, para. 89.

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with information from the bank's sustainability due diligence process, which should align with the expectations of the UNGPs and OECD Guidelines; screening for 'reputational risks' to the bank is relevant to the financial materiality assessment, but not to the materiality of impacts.

6. DMAS SHOULD BE BASED ON ESTABLISHED PROCESSES (NOT REPLACED BY UNENDORSED TOOLS)

While the granularity and quality of sustainability disclosures on material topics can be expected to improve over time, the ESRS contain clear 'transitional provisions' that explain how companies can deal with the lack of high-quality data in the initial years of reporting. These transitional provisions do not affect the legal requirements around the DMA and banks are not permitted by the ESRS to commence with a smaller number of impacts and add impacts over time, unless the impacts did not exist or could not have been known.

In our work with banks, we have heard that a desire to be "pragmatic" and "data driven" has led to reliance on external tools, the results of which have been used to justify a restrictive approach to the DMA. Neither the European Commission nor EFRAG has endorsed or scrutinized any tool that purports to help banks with their DMA. Users of tools should take care to understand the purpose of any tools and ensure that they are aligned with the ESRS criteria for double materiality assessments. These tools may be designed, and best used, as inputs to the DMA process. The bank will remain fully responsible for explaining why it found the tool credible and how it was used, and both internal auditors and assurance providers should be alert to this expectation.

7. CONCLUSION

Shift will continue to support effective and accurate implementation of the ESRS by highlighting key provisions of the standards in response to emerging risks of misinterpretation. We look forward to contributing to the development of any banking-specific guidance or disclosure requirements through our role in EFRAG's Sustainability Reporting Board. For now, the explicit reliance of the ESRS (and EFRAG's Implementation Guidance) on the international due diligence standards as the basis for impact materiality assessments, means that banks and assurance providers can lean on these standards in helping them understand how to conduct this aspect of their DMA . The strength of these standards, which were grounded in rigorous research, is borne out by over a decade of implementation by businesses and banks around the world. Guided by the standards, banks can avoid pitfalls and make sure they properly implement the CSRD.

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