Triodos Bank on reporting on sustainability
Position paper in regard to EU's Corporate Sustainability Reporting Directive proposal
28 April

Key message
The European Commission published a revision proposal of the Non-financial reporting directive (NFRD), which requires large companies and listed SMEs to disclose certain information on the way they operate and manage social and environmental challenges.

This is the perfect opportunity to reconsider the public information provided by companies, needed to enable banks and investors to make well-informed financial decisions to promote sustainability.

At the moment, banks and investors do not have all the relevant information to make these decisions. This has to do with the two different reporting frameworks for companies, the Accounting Directive and the NFRD. These have different scopes of application and different degrees of enforceability. The re-allocation of money towards sustainable causes is hampered by these incomplete and non-mandatory reporting requirements for companies.

Therefore, Triodos Bank encourages the European institutions to seize this opportunity of the revision of the NFRD to create one consistent reporting framework, including financial and sustainability information. Such a framework, with the same scope; same degrees of enforceability; proportional to firms' sizes; serving decisions better with materiality-concepts; and combining financial with impact information, would enable banks and investors to make well-informed decisions and steer their money towards sustainable ventures.

Background
'Making sure no one is left behind' has been the guiding principle of the European Commission for its plans and actions for a fair and green economy, since entering office in December 2019. The Climate Law turned the political commitment of climate-neutrality by 2050 into a legal obligation. The European Parliament's declaration of a climate emergency on 28 November 2019 and the European Council conclusions of 12 December 2019 endorsed the objective of achieving a climate-neutral EU by 2050. The European Commission rightly underlines that the ongoing COVID-19 outbreak shows the critical need to strengthen the sustainability and resilience of our societies; the ways in which our economies function; how it protects the vulnerable; and creates prosperity for all. The Sustainable Finance Action Plan, and subsequently the Renewed Sustainable Finance Strategy, translate these European ambitions into a political agenda for the EU's legislative framework for the financial sector. They aim at re-orienting capital flows from harmful towards sustainable activities, in a stable financial system that serves people and respects the planet they live on. The Sustainable Finance Disclosure Regulation (SFDR) for investment products was the first framework that enforces disclosure of investment products' contributions to this fair and green economy, followed by the CRR pillar 3 rules for banks, which should inform banks' stakeholders about their contributions to the EU's sustainability goals.

However, for well-informed finance decisions, concise and relevant information regarding both financial performance and impact on sustainable development of any company must be available to all. The current Accounting framework, and reporting requirements for financial undertakings, lack consistent impact-information that would serve balanced comparisons. Short term cashflow and stock-price-based accounting rules do no longer serve decisions regarding the viability of business models in a world challenged by environmental harm and social inequality, let alone regarding added value. Ideally, valuation methods should reward positive externalities and correct for negative externalities, in order to serve as determinants for longer term assessments of financial and sustainable soundness. The revision of the NFRD is an opportunity to reconsider companies' public information that is needed for well-informed finance decisions, aimed at sustainability goals.

The problem

International accounting standards and reporting rules as determinants for longer term assessments of financial soundness are meant to mainly inform banks and investors of corporations about financial value. They thus by design ignore the need of a broader set of stakeholders to be informed about a company's impact and added value, both financial and otherwise. The standards ignore subsidies for harmful energy-sources and negative impact of economic activities on people and planet, nor include positive non-monetary impact as a value. Since financial disclosure requirements do not include mandatory sustainability impact reporting, stakeholders cannot assess whether a company contributes to or harms the agreed Sustainable Development Goals, or the European Union's sustainable ambitions for that matter. The re-allocation of money towards sustainable causes is hampered by incomplete and non-mandatory reporting requirements for companies.

The current split accounting framework of the Accounting Directive versus the Non-Financial Reporting Directive, with different scopes of application and differing degrees of enforceability, hampers efforts by banks and investors and other stakeholders to collect relevant information about their investees and companies they engage in.

Suggested solution

A framework, with the same scope, same degrees of enforceability, proportional to firms' sizes, serving decisions better with materiality-concepts, and combining financial with impact information, would enable banks and investors to make well-informed decisions and steer their money towards sustainable causes. As stated in 'The CFO and the finance function role in value creation'[1], a report by the International Federation of Accountants, the CFO should turn into the CVO, chief value officer: "*Success requires creating and demonstrating value for all stakeholders, not just shareholders, and addressing societal expectations related to sustainability and broader impact, including a company's contribution to the Sustainable Development Goals*".

Triodos Bank presents five recommendations for a fundamental clean-up of the accounting and reporting rules, and as such pave the way to one consistent reporting framework, some of which have been included in the European Commission's revision proposal:

[1] The CFO and the finance function role in value creation, International Federation of Accountants, June 2020: https://www.ifac.org/system/files/publications/files/The-CFO-and-Finance-Function-Role-in-Value-Creation_0.pdf

1. Integrate the Accounting & Non-Financial Reporting Directive such that the same scope and the same timelines apply to all obligated parties, and that banks and investors can assess the combined financial & sustainability impact information sets and compare those across companies.
2. Require all corporates in scope to disclose their actual GHG emissions and requiring all financial undertakings to publish their financed or underwritten emissions.
3. Review materiality as in Article 2(16) to serve the broader economy, e.g. with the SASB Materiality Map®, and as such confine reporting to elements that matter for longer term value creation and serve decisions to that end.
4. Improve valuation rules applied to financial instruments, more driven by intrinsic long-term value for society rather than by temporary 'fair value' changes. Natural Capital accounting should be obligatory for the valuation of land as soon as comparable approaches are available.
5. Require use of Impact Performance Indicators (IPIs) in line with the EU's sustainability ambitions to replace the current key performance indicators.

1. Same scope (all companies >250 employees), same timelines

Fragmented reporting scopes and timelines are confusing and don't serve companies' and their stakeholders' needs for information that supports decision making. The Accounting Directive's scope in Article 1 should apply to the full set of financial and sustainability impact information.

Triodos Bank thus supports the Commission's proposal to expand the scope of application and include both the financial statement and the sustainability statement in the published annual accounts.

2. Disclose actual GHG emissions and financed emissions with GHG protocol

Given the EU's ambitions for 55% reduction of GHG emissions by 2030, tracking the progress towards that goal must be obligatory for any large or listed corporate, including their Science Based Targets for keeping on track to zero harm in 2050. Addressing the urgent challenge of climate change is more pressing now than ever. To limit global warming to 1.5°C above pre-industrial levels, all sectors of society need to decarbonise and collectively reach net zero emissions by 2050. The financial sector can facilitate the transition in line with the Paris Climate Agreement and as such, financial undertakings should report the carbon footprint of their financial exposures as much as non-financial undertakings will have to report their footprint. Measuring and disclosing the GHG emissions associated with the lending and investment activities of financial undertakings is the foundation to create transparency and accountability, and to enable aligning financial portfolios with the Paris Climate Agreement.

For smaller firms, estimates can be applied by financial institutions as shown in the PCAF Global GHG Accounting Standard developed by the Partnership for Carbon Accounting Financials (PCAF). Ratified by the GHG protocol, the PCAF standard is the result of the only industry-led initiative in the market that enables financial institutions to measure and disclose the GHG emissions of loans and investments. This standard, developed through an open-sourced and transparent approach, will simplify the comparison of carbon footprint information across financials, lower the costs of monitoring and facilitate financial institutions, their investors and their supervisors to monitor and manage progress towards

zero harm. It enables and simplifies reporting by making use of existing climate statistics and processing those in a manner that serves portfolio management for all financial undertakings. Rather than compete with existing frameworks, the carbon accounting standard developed by PCAF is complementary to existing climate initiatives such as TCFD, CDP, and SBTi, serving as the foundation to their fulfilment.

PCAF members are following their financed emissions in order to know the impact of what they finance, to achieve zero harm as soon as possible and to provide their investors with honest information about real climate impact. The harmonised accounting approach provides financial undertakings with the starting point required to set science-based targets and align their portfolio with the zero-harm ambition. PCAF enables transparency and accountability and provides an open-source carbon accounting standard.

The PCAF standard enables financial undertakings to determine their alignment with the climate change objectives as meant in the Taxonomy, as it encompasses the six main asset classes in financial undertakings' balance sheets and as such supports the determination of taxonomy-alignment of their total investments (listed equity & bonds, business loans, project finance, commercial real estate, mortgages, motor vehicle loans).

As a partnership of over 100 financial undertakings across the globe, PCAF facilitates data collection, as it makes use of existing climate data registers as much as possible (notably where it regards smaller debtors such as SMEs and households), and identifies gaps where more effort is needed to produce relevant information. It lowers the cost of setting up internal accounting systems by sharing methodologies, data and estimates, and as such simplifies the challenges commonly faced by financial undertakings in finding relevant information with respect to their climate impact.

Although Triodos Bank welcomes and appreciates EFRAG's expertise on the matter, we do encourage the EU institutions to specify in the level 1 text that the publication of actual, financed or underwritten emissions according to the GHG protocol becomes obligatory for financial undertakings, and not to leave that specification to the Delegated Act.

3. Materiality serving the broader economy, e.g. with the SASB Materiality Map®

There is evidence that companies report when legislation specifies disclosure requirements, e.g. GHG intensity in the UK and gender pay gap in Spain, as shown by the Alliance for Corporate Transparency. Yet, standards must balance the need for standardisation with the need to retain corporate discretion on materiality of information. The COVID-19 crisis has shown what will happen when economic and financial decisions ignore material impact on people. 'Material' sustainability information must be published, not only climate-related information, although the climate-emergency is most urgent and triggers many other kinds of negative impact, notably inequality. 'Material' would be the impact on a broad set of stakeholders, including the company itself, its owners and employees, clients, suppliers along the value chain, plus society and the environment, such that it would change a decision if the information would have been known. Financial market participants are eager to see non-financial information that helps them understand the material sustainability effects of a company's business model and operations. This can be environmental, social or governance related.

The NFRD identifies four issues that need to be addressed: (1) environmental, (2) social and employee issues, (3) human rights and bribery, and (4) corruption. Companies are required to disclose information about their business model, policies, outcomes, risks and risk management and other KPIs that are relevant to the business. But reporting on all detailed elements of these four categories is often not useful at all, even confusing. For example, the water consumed by a bank's office space is not material for the sustainability profile of the company, while its financed emissions are. Yet, the data on water use in the head office is collected, analysed and reported by many financial institutions, while financed emissions are not.

The Accounting Directive can solve this by requiring companies to:

a. Identify material themes/issues based on the company's core business and stakeholder needs. This can be done by conducting a materiality assessment with key stakeholders using a materiality matrix to define the most important impact KPIs, i.e. impact or sustainability performance indicators (IPIs). In developing the matrix, a wide range of stakeholders need to be consulted. Companies need to explain the steps taken to develop the matrix.
b. Report on the IPIs that were identified as most material in the matrix.
c. Share the impact data in a clear, easy-to-find and comparable way through a centralised open-source database.

The SASB Materiality Map® can be used for amending the definition of 'material' in Article 2(16). The materiality mapping makes it easier to compare companies within industries on material ESG related topics. Applying the SASB Materiality Map® would be a first important step to standardisation of materiality. The key benefit would be clarity and comparability, helping especially smaller corporates to implement reporting obligations cost-effectively.

Triodos Bank thus supports the Commission's suggestion that information must include *"qualitative and quantitative information, forward-looking and retrospective information, and information that covers short, medium and long-term time horizons"* and must serve decisions on contributions to the transition towards a fully and sustainable economic and financial system in accordance with the European Green Deal and the UN Sustainable Development Goals.

4. European correction of IFRS' fair value for negative externalities, notably for land

The definition of a 'fair value' used for measurement purposes of on/off-balance sheet items is quite broad within the IFRS framework and considers short-term oriented and volatile information (e.g. observable stock prices). These fluctuations are consequently also reflected in the temporary price fluctuations in financial statements and clearly support a short-term oriented economy instead of a long-term oriented value-based economy. The use of more long-term oriented valuation parameters for determining the value of financial instruments recorded in financial statements would force shareholders to rethink the purpose of their investment and would make it less attractive for short-term investors to realise monetary gains from temporary fair value fluctuations.

However, an objective approach to 'true value', i.e. a valuation that incorporates externalities, is still not available for most asset classes. But the most urgent asset class which value would need to be corrected in annual accounts, is land, or the use of land. The EU's economic prosperity and well-being is underpinned by its natural capital, i.e. its biodiversity, including ecosystems that provide essential goods and services, from fertile soil and multi-functional forests to productive land and seas, from good quality fresh water and clean air to pollination and climate regulation and protection against natural disasters. Yet, the value of land as an asset class on a corporate's balance sheet depends solely on its productivity, its production of goods, and its scarce availability, regardless their negative externalities. This implies an incentive for the exploitation of land beyond limits that would guard the added value of land, the natural capital, of the EU's economies.

The value of land on the balance sheet of companies, like for public bodies, must reflect its crucial role for prosperity and well-being. Natural capital includes the physical and biophysical components of an ecosystem working together to produce a flow of services to the economy and to society that support human well-being. The positive or negative impact of (financed) business activities on these components and thus on human well-being must be disclosed in a way that enables comparing various business activities and facilitates decision making in this regard.

5. **Obligatory Impact Performance Indicators in line with the EU's sustainability ambitions**

Demonstrating value creation or adverse impact for all stakeholders, e.g. contributions to the SDGs or harming them, would be a first step towards integrated reporting.

Most KPI concepts were developed during the long growth period of the old economy, which primarily put emphasis on the technical ratios measuring the performance, profitability (RoE) etcetera of a corporate in line with their individual corporate strategy and objectives. The success and contribution of such corporates towards a wider strategy and objectives (like a global sustainable economy) was not measured and disclosed so far. 'KPIs' as an accounting concept merely reflect what it is that the corporate monetises into profit, i.e. how it makes its money. Usually, fighting climate change for example is not something that makes the firm money. Moreover, the discretionary nature of publishing KPIs following the old Articles 19a and 29a, and the different scopes and timelines of financial vs non-financial annual reporting, complicated a balanced consideration of financial vs sustainability KPIs.

We thus advocate revisiting the existing KPI concepts for Articles 19a and 29a and creating a new concept, impact performance indicators (IPIs), which puts emphasis on measuring the corporates' success based on the EU's overall climate targets as well as the European Pillar for Social Rights. This would enable stakeholders' assessment of corporates' performance with regard to the UN's Sustainable Development Goals, given that the EU Climate Law and the EU Pillar of Social Rights encompass about all the SDGs, and it would enable regulators to follow the EU's performance regarding the UN SDGs. We welcome the Commission's proposal in the new Article 19b, linking sustainability reporting to the European ambitions, as well as the proposal to have EFRAG advise on the technical details of those reporting elements, but we advocate including a minimum set of concrete indicators in the level 1 text.

In particular for financial undertakings, the impact performance indicators would need to reflect the added value for:

a. the real economy, as meant by the IMF[2] in their studies into the correlation between inequality, financial stability and real economy finance. The Real economy assets ratio is defined as 'finance to the real economy / total assets'.
b. the green economy and the social economy in ratios as defined by the taxonomy,
c. carbon emission intensity and its materiality for the EU's climate ambitions, revealing hot spots within the economy and the financial system, defined as emissions per million or billion euros outstanding.

The balance sheet in the annual account of e.g. a bank would then reveal the various kinds of values added in the business. See for example the table below of the 2020 annual report of Triodos Bank:

GABV Scorecard of Triodos	*	*	*	*	*
Quantitative factors	**2020**	**2019**	**2018**	**2017**	**2016**
Assets Committed to the Triple Bottom Line to Total Assets[2]	73.9%	74.5%	76.3%	75.3%	77.0%
Assets Committed to the Real Economy to Total Assets[2]	75.4%	75.7%	77.4%	80.2%	80.6%
Revenues from the Real Economy to Total Income[2]	97.6%	96.6%	92.3%	90.4%	86.9%
Bank Resiliency through Earnings - 3 year Average Return on Assets	0.28%	0.32%	0.31%	0.37%	0.45%
Bank Resiliency through Capital - Equity to Total Assets	8.7%	9.9%	10.2%	10.2%	10.0%
Bank Resiliency through Asset Quality - Low-quality Assets to Total Assets	1.5%	1.1%	1.3%	1.9%	2.5%
Bank Resiliency through Client Based Liquidity - Client Deposits to Total Assets	84.6%	88.5%	88.0%	88.1%	88.4%

* IFRS - EU was adopted as of 1 January 2018, and therefore the figures for 2020, 2019 and 2018 are reported under IFRS. Figures for 2017 and 2016 are reported under Dutch Gaap.

[2] The assets and revenues committed to the Real Economy and to the Triple Bottom Line for the year 2016 have not been reviewed.

[2] Finance and Inequality, IMF, January 2020: https://www.imf.org/en/Publications/Staff-Discussion-Notes/Issues/2020/01/16/Finance-and-Inequality-45129