Materiality in ESG

Kristina Julie Rueter, Head of Methodology, ISS-Oekom

Abstract

Materiality has evolved over the years as a means to assess the most significant environmental, social, and governance (ESG) data reported by companies and accessed by investors. However, reporting standards have increasingly converged toward more uniform sets of predefined material issues in the interest of comparability between companies and portfolios. We apply a critical lens to this evolution and argue that, while standardization is helpful for setting minimum requirements as a starting point, an overly simplified and rigid approach to materiality precludes potentially material data from ESG assessment and does not allow to adequately prioritize or allocate weight among various material issues. For the benefit of successful sustainable investment strategies, we argue for a more nuanced, company-specific, performance-related, and forward-looking materiality approach in ESG research is needed before exploring the implications for ESG reporting requirements.

Section 1. Origin, Definitions and Interpretations of Materiality

The term materiality originally comes from financial accounting. The 1933 Securities Act had the objective to require stock corporations to publish, without exception, all material or substantial information which investors might need for a decision to invest into said stock. It follows, therefore, that information is material if it is important for investors and can influence their decision-making.
Today, this interpretation of materiality is cited among others by the prestigious and influential U.S. Sustainability Accounting Standards Board (SASB). It is also the cornerstone of paragraph 289 of the German Commercial Code (HGB), which implements the EU CSR Directive for companies on a national level. The interpretation and practical application of this definition of materiality has since proven inconsistent, both in the world of financial accounting, as well as in auditing, financial supervision and in the courts. Based on its general definition, materiality can be viewed as a characteristic inherent to all kinds of information and, above all, to information of quantitative as well as qualitative nature.

For decades, the concept of materiality has been perceived predominantly from a quantitative perspective in the realm of financial accounting and auditing. For instance, accountants and auditors have frequently operationalized a certain percentage of the balance sheet total (commonly 5%) as the materiality threshold. According to this interpretation and methodology, an item of financial information becomes material if its assigned value exceeds a fixed minimum amount (5% of the balance sheet total) and hence is immaterial if it lies below this amount.

As far back as 1980, the Federal Accounting Standards Board (FASB) cautioned against perceiving materiality (a) in purely quantitative terms, (b) based on a rigid threshold, and (c) bereft of any further context. To quote the Statement of Financial Accounting Concepts No. 2, Qualitative Characteristics of Accounting Information of FASB: “materiality judgments can be made properly only by those who have all the facts [and] magnitude by itself, without regard to the nature of the item and the circumstances in which the judgment has to be made, will not generally be a sufficient basis for a materiality judgment” (Kirk et al., 2018). The U.S. Securities
and Exchange Commission (SEC), which also bases its rules on the principle of materiality, published a statement in 1999 in which it asserted that while the amount (percentage share of the balance sheet total) may be suitable for use as an initial approximation, it cannot be sufficient on its own to rule definitively on the question of materiality (Katz, 1999). The courts have shared and confirmed this assessment. Besides the quantitative aspects, courts have also introduced the question of probability. In March 2011, the U.S. Supreme Court ruled: information is material if there is “a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the ‘total mix’ of information made available” (Dettmer et al., 2011). It would appear obvious that, with the introduction of probability as a relevant factor, the issue at hand involves far more than a simple decision with binary classification of information as material on the one hand and immaterial on the other. Moreover, the definition now includes the term reasonable as a qualifier to the word investor, adding yet another variable.

The entire complexity of materiality as a concept is laid bare in a 2015 publication by Singh & Peters at the Chartered Financial Analyst (CFA) Institute, who elucidate that information can very well be material despite an initial appearance to the contrary, and that materiality analysis must always be based on comprehensive information and prudent discernment: “In the materiality spectrum, certain items are clearly material and others are clearly immaterial. In the large grey area in between, however, significant judgment is needed when determining necessary disclosures. And information in this grey area that is useful for investment decision-making should not be omitted from the footnotes. Without such decision-useful information, investors are ill-equipped when they make their resource allocation decisions” (Singh & Peters, 2015).
Section 2. Materiality Evolution in Responsible Investment – From Values to Risk and Opportunity

To add even more complexity to the materiality debate, the concept of materiality has for some time been adopted by the responsible investment and non-financial reporting community, where, again, a uniform understanding and implementation of the generally accepted common definition struggles to emerge. To start with, responsible investment historically was not materiality-driven as it takes its origin from a strongly values-oriented perception: investors who represent certain values in a particular way (e.g., churches) were keen to avoid situations in which their investments promoted activities and developments that were clearly contrary to their ethical principles. They developed the first exclusion criteria, targeting tobacco, alcohol, and firearms, and eliminating companies that operated in these fields from their investments. Other exclusion criteria were developed over time, and further broken down into more nuanced screens. Concurrently, selection based on positive criteria emerged as additional approach within responsible investment. Until the early 1990s, sustainable investment remained the preserve of a select group that cited primarily ethical values, such as church investors, foundations, and small specialist banks. It was a matter of conviction, one in which investment selection focused less on risk and return and more on the alignment with personal or institutional values.

Over the last ten to twenty years, we have seen a global consensus evolve on many sustainability issues, embraced by society as a whole. On the other hand, the capital market players have come to realize that non-financial information can significantly contribute to risk assessment – and is therefore material. Membership in the PRI (Principles for Responsible Investing) has grown to over 1,800 members since its inception in 2006, representing nearly $70 trillion in assets as of April 2017 (PRI, 2017). As reported by the Financial Times in June of this
year, the war for talent in ESG is increasing among asset managers (Thompson, 2018). This realization did not occur entirely by magic. Experiences and events over the last two decades – which were both surprising and painful for investors – have raised questions and triggered a rethinking and learning process in politics and finance.

For instance, the major accounting scandals in the early 2000s, with subsequent bankruptcies and market value collapses (e.g., companies such as Enron or Parmalat), as well as far-reaching corruption scandals (e.g., Siemens in 2006) got investors’ attention. The incipient financial crisis that emerged in 2007 ultimately precipitated a fundamental reappraisal of the value of traditional financial analysis as the sole basis of investment decision-making (Christensen & van der Helm, 2010). Accordingly, interest in responsible investment strategies and non-financial sustainability information increased measurably as evidenced by the latest Global Sustainable Investment Review published by the Global Sustainable Investment Alliance (GSIA) (Passant et al., 2013).

Ever since 2010, the increasingly accelerating crisis in Greece and the Eurozone had investors realize that seemingly soft ethical topics (e.g., bad governance or corruption) have the power to seriously jeopardize entire monetary systems (Haas, 2013; Kouretas & Vlamis, 2010). More recently, events such as the Deepwater Horizon environmental disaster (2010), the Fukushima nuclear catastrophe (2011), and the Volkswagen diesel exhaust scandal (2015 and ongoing) have dramatically demonstrated the significance of environmental risks and externalities. There is no doubt that the impacts of the kind of incidents as listed above were or still are highly material, not only for the population and the environment, but also for the companies and investors involved. Investors were able to anticipate some of these trends in advance through the consideration of substantiated ESG information: For example, ESG rating agency ISS-Oekom (formerly Oekom Research AG) had awarded Not Prime status to BP and Tepco, as well as to
Greece and other countries affected by the Eurozone crisis, well before the disasters involving these issuers unfolded. These assessments were directly linked to systematic shortcomings in the management of the particular ESG risks that eventually culminated in the respective crises. BP in its Corporate Rating was never awarded *Prime* status since Oekom Research commenced rating it about 15 years ago, well prior to the Deepwater Horizon disaster. The reason was weak performance regarding the material and thus highly weighted topics of *health and safety* and *environmental safety of operations*. In 2009, the Corporate Rating of BP observed the company’s involvement in various high-risk operations (e.g., in arctic or deep-sea environments), which went with a pattern of decision-making that neglected obvious risks (i.e., late/omitted maintenance of structures although early signs for failure of structures were already apparent). Its track record of recurring safety incidents and environmental spills and accidents resulted in the *Not Prime* assessment. Likewise, the Corporate Rating of TEPCO was *Not Prime* prior to the Fukushima catastrophe. ISS-Oekom’s methodology assessed a weak performance regarding the material and thus highly weighted topic of nuclear safety, as various nuclear safety incidents had occurred in the years prior to the Fukushima catastrophe. While TEPCO had implemented some measures to ensure facility safety and to enhance emergency preparedness, starting in 2010 already, ISS-Oekom analysts had identified as a material risk that no information was made available by the company on such topics as liabilities, procedures, and measures to be taken in the event of a maximum credible accident (MCA).

In the case of Greece, the exclusion criterion or negative screen of *corruption* had been activated by ISS-Oekom analysts prior to the crisis, reflecting the widespread corruption in Greek society and the inefficiency of the Greek administration as well as the judiciary. The latter was also considered as not being independent. The country rating indicator *Central Government Debt*
reflected the disproportionally high sovereign debt. The evolving events nevertheless caught broad swaths of society, with the business community and capital markets largely unprepared. Lessons were learned on different levels from all the aforementioned issues, resulting in action which we will discuss next.

Particularly noteworthy examples of this shift of awareness can be found in the Sarbanes Oxley Act (2002) and the Dodd Frank Act (2007). This legislation mainly addressed aspects such as the reliability of reporting, increased transparency, and improved corporate governance, and came about in response to accounting scandals like the ones listed earlier. The catastrophic events of Fukushima were a major impetus for the German government’s decision to phase out nuclear power by 2022, thereby intensifying measures to initiate a sweeping energy transition (Energiewirtschaftliche Tagesfragen, 2013).

Internationally, the awareness of an increasing urgency to fight climate change and, at the same time, discouraging investments in stranded assets, culminated in a broad movement calling for coal divestment as well as the Paris Agreement to combat climate change. Over 1,000 organizations and 59,000 individuals have pledged to divest and/or invest, representing over $6 trillion in assets, while on the sovereign level China has stepped up its efforts significantly (Li, 2016; UN Climate Change, 2018). Many countries, above all France, accelerated their efforts to reform legal frameworks, introducing changes which, among other things, required investors to measure their carbon footprint and to publish their status regarding climate risks and opportunities (Philipponnat & Couste, 2016). The UN Sustainable Development Goals, adopted in September 2015, created a globally accepted framework for action within sustainable development, sustainable management and responsible investment that in many instances had been acknowledged already.
Even though the political trends in recent years have, in some countries, contradicted the sustainability consensus and at times even disavowed fundamental social and ecological values and agreements, the insights gained regarding the significance and materiality of sustainability issues continue to be a factor in the comprehensive assessment of investments. We see this confirmed by several factors: European sustainable finance initiatives, such as the recommendations of the High-Level Expert Group (HLEG) and the establishment of the Technical Expert Group on Sustainable Finance, the continuing growth of the green bond market, and the U.S. capital market’s growing interest in sustainable investment.

Today, most of the European capital market actors and a significant and steadily expanding share of preeminent investors and asset managers in the United States regard the consideration of sustainability information (i.e., environmental (E), social (S) and governance (G) aspects), as important if not indispensable when looking for a complete assessment of material opportunities and risks. Incorporating these insights is seen as essential in assessing potential returns of an investment. As such, fundamental acceptance of the materiality of ESG information has finally become mainstream, also evidenced by Larry Fink’s 2018 *Annual Letter to CEOs* titled “A Sense of Purpose” (Frink, 2018).

**Section 3. Requirements for addressing materiality and comprehensiveness in (responsible) investment**

The basic principles of *comprehensiveness* and *materiality* are frequently played off against each other and presented as contradictions in the requirements defined for integrated (i.e., financial and non-financial) corporate reporting, in ESG research, and in sustainable investment:
• An understanding of materiality that is framed in very narrow, financial, and microeconomic terms and which accepts information as material only insofar as it directly and immediately impacts the latest balance sheet.

• A significantly more expansive or sustainability-oriented view of materiality that includes all conceivable stakeholders (based on this approach, everything affecting stakeholders or the environment to a certain degree is material).

Materiality analyses using both approaches often attempt to assign general topics and any information they contain to the categories of *material* and *immaterial*. Information deemed material is then included in the reporting, and it is a prerequisite to assess this information in ESG ratings and consider the resulting signal in investment decisions. Information considered to be immaterial is omitted from the reporting and thus excluded from any further process of assessment and consideration. We will pick up on this important point later in this paper.

ESG research in particular has been faced for years with the call to identify and assess a small, manageable (i.e., single-digit) number of key performance indicators (KPIs) with significant predictive power and materiality and to make them available, ideally, as quantitative information that can be used for the smooth and simple integration of all non-financial aspects within financial analysis. But contrasting *financial* materiality with its *sustainability* or *stakeholder-related* counterpart and the excessively simplified classification of information into merely two categories (i.e., *material* and *immaterial*) are both unrealistic. Reducing an issue of this complexity to a binary classification and concentrating on a handful of KPIs will not ensure that the most significant opportunities and risks of investment decisions and corporate management are successfully identified, measured and hence given their due consideration.
An approach that narrows the equation to conventional economic and financial aspects will always be inadequate, as many aspects that are, at first glance, non-financial may inherently include direct or indirect economic and financial implications and are therefore, even in a stricter sense, equally material from a purely economic perspective. This applies first and foremost to managing climate risks and the *carbon footprint*, for which financial materiality is manifestly evident in the form of political decisions and the tighter regulatory frameworks they introduce. This development explicitly shaped the term of *stranded assets* for investments in coal and crude oil projects that will no longer materialize or may even be prohibited, and hence must be written off or reported as losses.

Reducing the horizon of a general or industry-specific appraisal to just a few aspects or indicators will automatically lead to the loss of information that is or may well prove highly material in individual cases. One example for relevant material information that might be omitted with a narrower horizon, but later proven to be material in individual cases, is the information on supply chain management in industries where the respective risk exposure is not obvious at the time or does not apply to the entire industry. Numerous industries have a tradition of vertical integration and production in developed countries with high working standards. However, as companies within those generally less exposed industries eventually outsource production to countries with higher risk exposure or start purchasing raw materials with complex supply chains originating in countries with violent conflicts, human, or labor rights issues, supply chain management will very likely become a material issue. We can point to examples in the automotive and machinery industry, where often supply chain management is not considered a material issue. Yet recently, severe cases of child labor in General Motors’ cobalt supply chain
were revealed, as well as labor rights controversies within Kawasaki Heavy Industries Myanmar supply chain.

While a holistic appreciation will allow for monitoring and recording of these effects and assigning them their appropriate weight – as explained later on, users of isolated KPIs will have to be aware that certain risks will be flying below their radar. It is our observation that the commensurate risk will rise in an inverse relationship to the number of KPIs that are considered. This fact is illustrated plainly by the numerous failed attempts to infer and validate the predictive power and materiality of just a few KPIs. Any restriction to a smattering of KPIs or data points that need to be included in investment considerations is only possible at the end of a process in which not only the materiality of all issues that are relevant to a company and its business model have been reviewed ex ante, but in which the same materiality has also been validated once more in the course of performance analysis. Examples of issues that possess a particular materiality component that may not become apparent until after a holistic examination of the individual company include discrimination, money laundering, data protection, and fraud. Across the board, these issues would not necessarily rank among the top-five key issues in all sectors and organizations, although they can lead to very substantial financial risks when managed poorly. Examples include media companies, which have seen a rising number of material controversies: last year more than 20% of the large listed media companies in industrial countries assessed by ISS-Oekom have been found implicated in severe or very severe controversies contravening the principles of the UN Global Compact (Rueter et al., 2018).

Criticism has been directed at the varying materiality concepts, their applications, and findings, as well as at the organizations that use them. ESG research providers in particular have to defend the means and ways by which their methods, processes, and findings implement the
principle of materiality. For instance, the *Deep Data Delivery* standard established in 2016 by investors, asset managers, and representatives of university research (Hoepner et al., 2016), insists on datasets comprising at least 30 independent indicators.

Reintroduced in 2018, an updated version of the 2010 *Rate the Rater* research program by SustainAbility, which aims to exert a positive influence on the quality and transparency of sustainability ratings, voices several points of contention that were identified in roundtable discussions and interviews with corporate sustainability managers, investors, and analysts. Among other things, these aspects include an overly simplistic approach within ESG ratings: “Sustainability and ESG issues are nuanced and complex. They require context to fully express performance implications. Reducing analysis of an issue to a single number or grade, let alone a single number across multiple issues, is difficult and perhaps even misleading. Ratings that don’t offer context risk not showing the full picture.” The scientists also criticize the insufficiently flexible consideration of individual business models in the appraisal of materiality: “Companies also note ratings struggle to benchmark unique or evolving business models (Wong, 2018)”.

A recent publication by Timothy M. Doyle for the American Council for Capital Formation in July 2018 directs a number of criticisms at ESG ratings, including that “ESG agencies oversimplify industry weighting and company alignment.” It proposes the following recommendations:

- “ESG ratings need to adjust for company size, geographic reporting, and industry sector differences.
- ESG rating agencies need to be transparent on how E, S, and G factors impact scores and prioritize those that are material.
• ESG rating agencies should be carefully compared and should fully disclose their success rate in protecting investors from large underlying risks” (Doyle, 2018).

It follows, therefore, that a significant discrepancy exists between the general acceptance that ESG information is, on the one hand, material in nature, and the critical appreciation on the other of how and by which means ESG research identifies materiality, assigns value to it in rating methodologies, and models its findings.

Section 4. Materiality in Regard to Sector- and Company-specific Sustainability Risks, Opportunities and Performance

Assuming the definitions and explanations provided above are correct, most sustainability aspects possess a certain degree of materiality from an economic and financial perspective, and are therefore relevant to investors as they can directly or indirectly co-determine the short- or long-term financial development of companies. Therefore, it is important to recognize, correctly evaluate, and quantify the ESG factors that are crucial to the future viability and financial performance of companies. To ensure this, complex relationships and dependencies between a variety of factors and parameters need to be recognized and considered. There is widespread agreement that this requires very specific experience and expertise. While existing standards on ESG disclosure and research are important as guiding frameworks setting the basic requirements, only a comprehensive materiality analysis at the company level based on comprehensive information on the very individual and specific business model is able to consider all of the variables, including locations, type of operations, supply chain, and business relationships. This analysis must be performed thoroughly and with appropriate expertise in all areas under review and for all sustainability issues not only across all sectors but also for each company. To produce
meaningful ESG research, the findings obtained from such analysis must serve as the basis for industry- and at times company-specific indicators and weights.

The question of time is another important aspect when considering materiality. The issue of climate change is a good example of how the concept of materiality is imbued with its intrinsic dynamic: initially scorned by investors as an aspect bereft of materiality, the situation has changed entirely in recent years. Companies and investors are well advised to address the questions of adaptation and mitigation, even without any pursuit of sustainable management. This indicates that there is no static or binary decision on what is or isn’t material, and that instead the process of answering the question as to what is or is likely to become material, to which degree and within which specific timeframe, must be performed repeatedly, on an ongoing basis.

In summary, the following must be ensured and guaranteed to perform resilient materiality analyses, and on that basis provide companies, investors, and asset managers with ESG research that can deliver added value in regard to the assessment of opportunities, risks, and performance:

- No restriction to solely quantitative performance indicators/aspects
- Consideration and assessment of qualitative aspects in the context of the analyzed company
- Analysis performed by professionals with consummate understanding, experience and discernment
- Materiality analysis and performance requirements for specific sectors and even companies in order to consider individual business models and risk scenarios
- Graded and nuanced materiality analysis and performance assessment to avoid overly simplified black-and-white appraisals that lead to erroneous conclusions
- Consideration of different probabilities, timeframes and future scenarios to create genuine added value through predictive assessment of corporate viability, rather than recapping what is already evident today
- Regular review and adaptation of the materiality analyses and the assessment methodologies

The following will outline how these requirements can be put into practice successfully. It is feasible to produce reliable assessments of companies regarding their sustainability management and thus their performance. It is equally possible to determine how these factors impact the material sustainability-based challenges, risks, and opportunities of their core business, along the entire value chain within their specific sector and organization. Hence, it is possible to provide investors with resilient material forward-looking, non-financial information for their investment strategies and decisions.

Given the present state of the industry, it is our view that the following preconditions and methodological principles are necessary to satisfy these requirements:

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<th>Requirement</th>
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<td><strong>Company-specific qualitative materiality and performance analysis considering individual companies’ business model and context</strong></td>
<td>Highly educated, experienced, and appropriately specialized analysts performing sector- and company-specific materiality analyses based on company and third-party information, resulting in the appropriate selection and weighting of relevant indicators and the establishment of performance requirements.</td>
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| **Forward-looking, predictive assessment of ESG performance and corporate viability** | Use of qualitative indicators for a qualitative performance assessment can allow how and with which likelihood of success a company addresses sustainability-related risks. Taking into consideration the risk/likelihood of occurrence, as well as the extent and timeframe of material ESG risks by acknowledging:
  - The individual business model and its envisaged evolution
  - Specific regional and local circumstances and risks, both current and foreseeable
  - Current and evolving regulatory frameworks
  - Status of science and technology |
| **Holistic consideration of the entire value chain and relevant externalities** | Besides the operating business, which is controlled directly by the company, it is also essential to consider:
  - Its supply chains
  - Business relationships with subcontractors |
| Use of products and services | Reconciliation of principles of comprehensiveness and materiality, which may appear contradictory. This should be done by means of a comprehensive and inclusive assessment with materiality-based, flexible, and dynamic weighting of the individual aspects considering the specifics of the sector and the company. |
| Disposal of used products | An assessment of actual performance, i.e., not a mere company disclosure assessment, which is verified and verifiable, complete and balanced. |
| Its active or passive collaboration with governments and law enforcement agencies in countries with authoritarian regimes and human rights issues | Examining company and external sources, as well as statutory/local circumstances for a complete, balanced and verified assessment of material factors. |

An important prerequisite for all the above is transparency, reporting, and data availability.

For high-quality ESG research to provide maximum added value for investors, comprehensive reporting and availability of ESG data is required.

While GRI and SASB have proposed very useful industry-specific guidance for reporting, the reliable identification and measurement of all material risk- and opportunity-related performance aspects in the case of individual companies may require additional data points, resulting in a broader set of relevant and potentially material indicators to be monitored and reported upon.

Such ESG assessment requires appropriate flexibility via definition of weighting scenarios for certain business models and reappraisal rules for specific performance constellations (e.g., weighting of opportunity- and risk-related aspects, status-quo vs. forward-looking assessments, downgrading due to controversy) to ensure that ESG performance scores duly reflect, quantify, and balance material risk and opportunities.

Corporate non-financial or ESG reporting should thus not limit itself to a predefined industry-specific set of obvious material issues – possibly extended or adjusted based on internal materiality assessments. It should be comprehensive and inclusive, allowing third parties to base
a more detailed and already performance-oriented additional materiality analysis on the reported data.

ESG research which adheres to the above principles in its methodology and processes and which conducts forward-looking sustainability performance analyses provides investors with highly valuable material non-financial data. It is such research that enables investors to reliably identify and quantify material risks and opportunities not captured by pure financial research, as the following evidence for the materiality of holistic, forward-looking sustainability performance analyses following a dynamic sector- and company-specific materiality approach will illustrate.

Numerous longtime studies confirm the financial materiality of sector-specific holistic sustainability analyses, demonstrating that the financial performance – and the share price or bond value – of companies engaging in more sustainable management, is above par and that selecting such issuers protects against loss of value. As will be shown, this applies also to the sustainability analyses of sovereign countries as issuers of government bonds.

At this point, we want to reiterate again that a multitude of studies confirm that the additional consideration of non-financial information in general has not shown detrimental impact on returns on investment. Rather, in most cases, its inclusion resulted in positive impacts. For instance, a 2015 meta-study by the University of Hamburg and Deutsche Asset & Wealth Management, based on the analysis of 60 meta-studies with over 2,000 individual studies, demonstrated that in most cases the integration of sustainability criteria in investment decisions has positive effects on the investment result: almost 63% of the studies show a positive correlation, while 90% reveal a relationship between ESG factors and the profitability of capital investments that is not negative (Friede et al., 2015).
A study by Deutsche Performancemessungs-Gesellschaft (DPG) and Oekom Research validated the significantly higher return on equity investments that are based on sector-specific holistic sustainability analyses and which satisfy the above outlined requirements. The findings of the study confirm that large-cap companies which received a positive sustainability rating from Oekom Research (i.e., Oekom Prime Portfolio Large Caps) achieved a higher return than the MSCI World Total Return Index for the January 1st, 2015 to December 31st, 2016 period, with 8.59% per annum for the Oekom Prime Portfolio compared to the MSCI index which reported 8.41% for the same period. This result confirms the inherent materiality in ISS-Oekom’s Corporate Ratings and its company-specific materiality analyses with its assessment requirements and findings (Oekom, 2018). Investments in corporate bond issues are another example of the correlation between the sustainability assessment via ISS-Oekom Corporate Rating and financial risk: the 2014 study by VIF Consulting and Oekom Research, which analyzes the correlation between the Oekom Corporate Rating and the equity ratio of assessed companies, as well as the credit spread associated with the bonds issued by these companies, showed that the sustainability performance measured by Oekom Research correlates negatively with the financial risk (Hassler, 2014).

In regard to the sustainability analysis of sovereign countries as issuers of government bonds, the 2016 study by Andreas Höpner et al. found that the Oekom Research ratings for European countries hardest hit by the debt crisis following the financial crisis were downgraded faster and earlier than the credit ratings by Moody’s & Co and that, in this case at least, the ratings by Oekom Research possessed greater predictive power in regard to material risks. As a concrete example, the ISS-Oekom Country Rating for Greece foresaw the deterioration in the creditworthiness of Greek bonds much before the Big 3. Equally, the ISS-Oekom Country Rating
issued warning signals for Portugal way before Moody’s and Fitch. There were similar signals for Ireland, Italy, and Spain (Hoepner, 2014).

The development of the Global Challenges Index, initiated by the Hanover Stock Exchange in collaboration with Oekom research in 2007, is a particularly impressive example for the materiality of high-quality ESG analyses and the resulting stock selection. Stock selection for inclusion in the GCX is based exclusively on sustainability research by ISS-Oekom. The 50 companies from Europe and the G7 nations must have been awarded a Prime Status Corporate Rating, cannot violate any of the defined exclusion criteria, and must also make a particular contribution to overcoming global sustainability challenges (CGX, 2013). With an index performance development of 161.32% and an index price development of 104.14% since its launch on August 30, 2007 (as per August 14, 2018), the GCX outperforms lead indexes like the S&P 500 (index price plus 94.83% in the same period), the Dow Jones (index price plus 91.11%), the German DAX30 (index performance plus 64.35%), and the Euro Stoxx 50 (index price plus 12.36%) as well as other sustainability indices, including the FTSE4GoodGlobal and the DJ Sustainable World, by a notable margin.¹
As an interesting aside, stronger performance in selected sustainability topics can also be connected to better overall sustainability performance as a recent study published in ISS-Governance Insights shows. Here, the relationship between board gender diversity and Environmental & Social (E&S) management is being examined for the companies in the S&P 500, indicating that companies with gender diverse boards are associated with better overall ESG performance (Banahan & Hasson, 2018).

**Conclusion**

High-quality ESG data identifies risks and opportunities that financial research alone is not able to capture. As the relevance and potential materiality of ESG information in general has become widely recognized and led to a mainstreaming and increasing integration of ESG data in investment strategies and decisions, concern and criticism has been emerging on the quality of
certain ESG research methodologies, processes, and results, with the materiality concepts applied being at the root of much of this criticism.

It is crucial to recognize, correctly evaluate, and quantify those ESG factors that can influence a company’s future profitability and financial performance. In doing so, the complex relationships and interdependency of a variety of factors and parameters must be recognized and considered. Comprehensive materiality analysis is required to account for these variables and must be performed for all sectors and for every company, with regard to all assessed areas and sustainability topics, leading to a nuanced sector-based approach. While not proving causality, a series of independently conducted performance studies, commencing in 2005, does confirm the validity of this approach. The fact that some remaining risks that cannot be identified by neither financial nor ESG research should not obstruct the view on the benefits of high quality ESG research for investors and asset managers in identifying risks and opportunities that financial research alone is not able to capture.

SASB and GRI provide excellent starting points to give orientation on sector-specific materiality. Yet, if reporting on a company level is limited to sector-specific materiality guidance, it may be that material information on the company level that would be relevant for a full ESG risk, opportunity, and performance assessment is omitted. We propose more comprehensive reporting and data collection since the final materiality assessment will also depend on the individual company situation and sustainability performance.

Further work needs to be done to establish standards not only around the materiality assessment to determine reporting requirements, but also around the weighing of individual ESG performance aspects.
References


**Endnote**

1 The GCX performance figures are based on research by the Hamburg and Hanover Stock Exchange (Börsen AG Hamburg and Hannover). The BÖAG gave the permission to cite it as the source of the data.