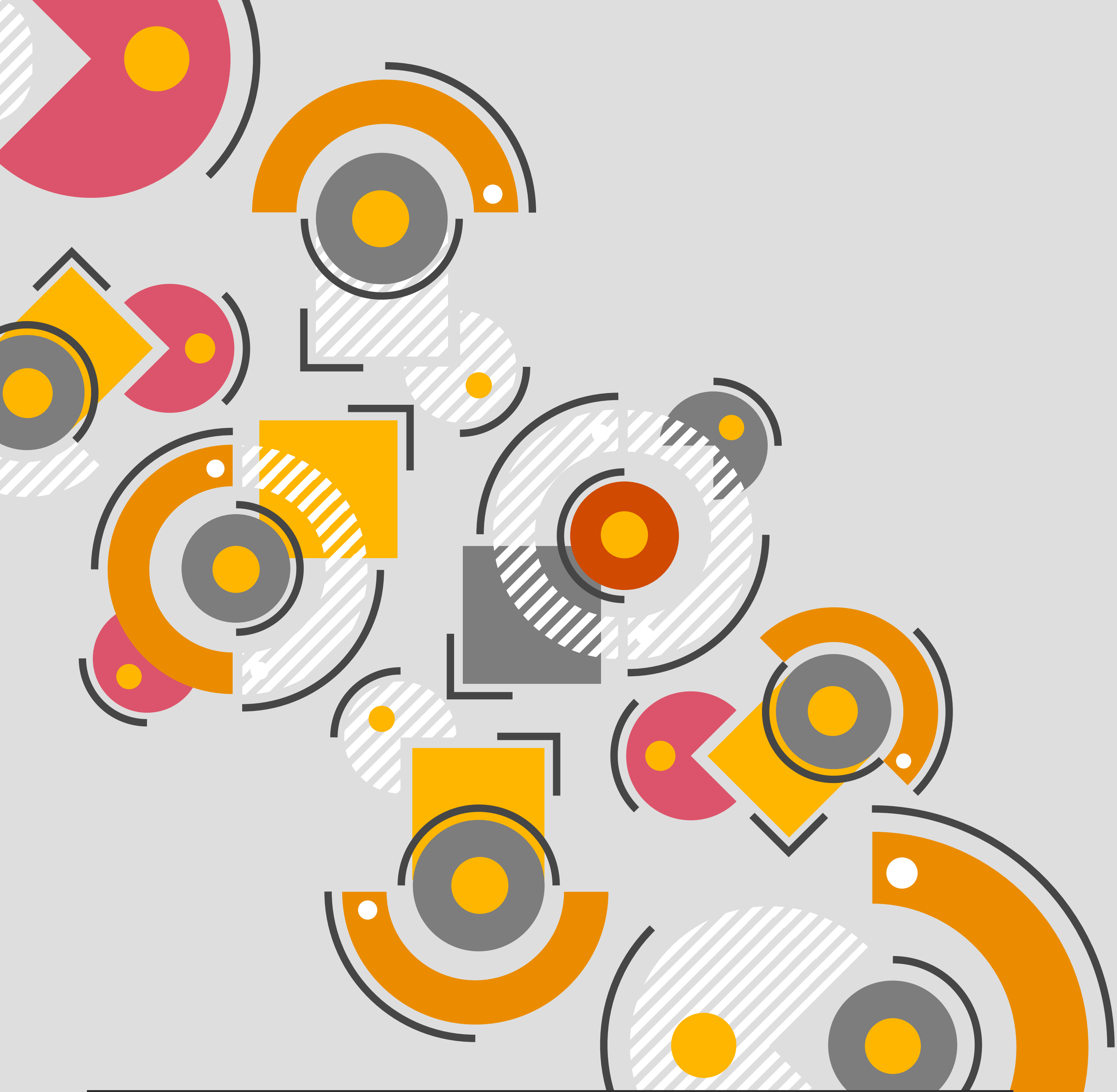

ESG trends in 2022

Key ESG areas to keep a watch on in the coming year

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Following a lightning strike year for ESG in 2021, 2022 looks set to follow suit. We anticipate there are five key areas organisations should keep their eye on:

1. Global move to align capital markets with sustainability goals through standards and regulation
2. Biodiversity and natural capital becoming a greater focus with increasing recognition of risks and opportunities
3. Focus on Scope 3 emissions in climate change related reporting
4. Science based net-zero targets becoming the norm
5. Australian regulators set to look seriously at ESG credentials and exposure to ESG-related risks

Accelerated global standards development

ESG regulation is no longer a question of 'if' but 'when' and 'to what extent'. Within ESG, Sustainable Finance standards and regulation will continue to progress rapidly in 2022. While jurisdictions differ in their exact approach, progression is expected across:

1. taxonomies of sustainable activities (defining how an activity of a company may be deemed sustainable) for companies or investments,
2. sustainability disclosures for both companies and financial products, and
3. sustainable finance benchmarks, labels and certifications.

While a regulation's applicability may be 'jurisdiction specific', impacts are felt globally as regimes seek to capture subsidiaries of third countries entities, and financial products sold in a local market.

The European Union (EU) continues to be a leader in Sustainable Finance development. This year, anticipated notable developments include:

- **Taxonomy extensions:** Expanding the taxonomy towards four additional environmental objectives and proposals that extend it to additional performance level definitions: 'intermediate performance', 'in need of urgent transition', and 'no impact', as well as looking to determine the principles behind future 'social taxonomy'.
- **Corporate Sustainability Reporting Directive (CSRD):** CSRD will mandate sustainability reporting for any large and/or listed EU (including those of non-EU/third country parents, and non-EU subsidiaries of EU parents) – with the final directive text and standards anticipated to expand beyond the International Sustainability Standards Board (ISSB's) standards.
- **Other:** Regulations regarding corporate due diligence (including mandatory supply chain examination), and Green Bond Standard to be finalised.

Close behind is the United Kingdom (UK), who in 2022 will continue implementing mandatory Task Force on Climate-related Financial Disclosures (TCFD)[1] reporting, and broader sustainability reporting across its market. Broader requirements expected will address sustainable finance product labels, and a UK-taxonomy (based on the EU's). While application outside of the UK is currently unclear, UK-domiciled subsidiaries should monitor the situation, with thresholds for application expected to lower over the proceeding years to increasingly capture more and more companies.

Asia is adopting the EU/UK trend in establishing a sustainable finance framework, with a number of jurisdictions developing their taxonomies – including, Singapore, Japan, Malaysia, India, Indonesia and Thailand. ASEAN has released a blueprint for an overarching taxonomy framework that member countries can build on. China continues to collaborate both with the EU (notably continuing the work on a Common Ground Taxonomy) and the US. While previously focussing on the environment, Asian countries are starting to address social issues, including gender diversity at companies with Japan and South Korea taking steps to legislate on this.

Across the Atlantic, an increasingly active Securities and Exchange Commission (SEC) in the US is looking to establish climate disclosure rules. As a result, capital raising in the US will likely continue their trend of requiring a 'strong' ESG story.

Finally, the ISSB, who released two prototype standards focusing on general requirements and climate change in 2021, are expected to release their exposure drafts for consultation in the first quarter of 2022.[2] The ISSB are seeking to issue final standards by the end of 2022 to provide a global, consistent and comparable sustainability reporting framework. Once released, we expect many companies will attempt to comply voluntarily, before any local endorsement/enforcement of the standards, to demonstrate their commitment to sustainability.

Natural capital: Emerging recognition of risks and opportunities

While climate change has been taking centre stage in ESG considerations both by governments and private markets, the world is taking increasing note of the equally concerning and inherently connected issue of biodiversity loss.

Biodiversity and other elements of natural capital (e.g. water, soil, air) are in crisis due to human activities, which include destruction of habitats, pollution and the effects of climate change. The current risk facing biodiversity (sometimes referred to as the 'sixth mass extinction event'[3]), and the rapidly deteriorating state of other natural capital – creates an economic threat, with highly dependent supply chains and companies facing risks of availability, quality, and certainty over critical inputs.

Over half of the world's economy is dependent on natural capital[4] and in a recently released report Robeco, an asset manager with ~$AU300 billion in AUM, identified one third of their portfolio as exposed to nature-related risks (impacts and dependencies). Furthermore, our ability to address climate change risks hedges on maintenance and restoration of healthy ecosystems as around 40% of our greenhouse gas emissions are being absorbed by nature[5]. Without these 'natural carbon sinks' the impact of climate change will most likely exceed our capacity to withstand them.

In recognition of this risk, last year the Taskforce on Nature-related Financial Disclosures (TNFD) was launched, with the appointment of 35 financial services, corporate and professional services entities[6]. Building on the success of TCFD, it aims to develop a risk management and disclosure framework for nature-related risks. In January 2022, TNFD announced partnering with leading international organisations[7], including other standard-setters, among them SASB, GRI, WBCSD.

The first TNFD output – a beta version standard – is to be expected already in early 2022, followed by extensive piloting by stakeholders. In Australia, the Responsible Investment Association Australasia (RIAA) Working Group on Nature plans to work in close alignment with the TNFD process, and is devising several outputs starting in 2022 to support Australian and New Zealand investors interested in nature-positive investments. Further action is being taken by the Science Based Targets Network that is likewise developing a framework for companies to set science-based targets for natural capital with initial guidance already available and further methodologies to be released in 2022.

In April 2022, the second phase of COP15, the biodiversity summit, will take place in Kunming, China[8]. Similar to the well known climate 'COPs', it aims to finalise and adopt a post-2020 Global Biodiversity Framework – a 10 year roadmap for reversing nature loss. Several targets are calling for the private sector to assess and report on dependencies and impacts on biodiversity, as well as substantially reducing negative impacts and increasing positive ones. It also aims to envision strategic integration of biodiversity considerations across all sectors to align financial flows with biodiversity preservation.

Companies and investors are progressively assessing their nature-related dependencies, risks and opportunities (for example, the ACSI report on natural capital value for investors[9]). As companies become more well-versed in both climate and natural capital risks and opportunities, they will increasingly design more integrated and fulsome responses that address broader strategic, data, risk and opportunity aspects arising from these two mutually reinforcing issues.

Climate change: Focus on Scope 3 – Emissions in value chain

Greenhouse gas emissions are universally split into three groups for reporting purposes:

Scope 1: From sources directly owned or controlled by a company – meaning that the source of the combustion or creation of the emissions is owned by the company. For example, the running of building facilities or fleet vehicles.

Scope 2: From energy purchased by a company. For example, purchasing heating, cooling, or electricity.

Scope 3: From all other activities in a company's value chain; capturing emissions not controlled by a company, but caused by their activities. For example, purchasing goods or services or commuting to work.

While Scope 1 and 2 are relatively easy to understand and are commonly reported, the true footprint of a company can only be understood when Scope 3 emissions are considered. As stakeholders become more ESG savvy, we anticipate a greater focus on Scope 3 over the next 12 months. Companies that don't report will likely find others (investors, rating agencies) estimating their Scope 3. This is particularly true of climate commitments made of companies which, in the absence of Scope 3, can become meaningless and lead to claims of greenwashing.

Companies like ExxonMobil[10] and Saudi Aramco[11] have received backlash for excluding Scope 3 in their net zero targets, which can comprise more than 90% of total emissions in their value chain – and groups like Net Zero Tracker[12] are taking note. Regulators too are focusing on Scope 3 – notably in the UK and the EU where Scope 3 reporting is required for certain companies. Additionally, in 2022 the ISSB will likely see a greater examination of both whether – and how – companies have reported this aspect of their emissions profile.

What are financed emissions?

In current carbon accounting models, ownership of greenhouse gases (GHGs) associated with investments and lending activities is considered part of a financial institution's carbon footprint. Specifically, GHG protocol accounting standards define these GHGs as Scope 3 Category 15 emissions, or financed emissions. Lending and investment are not the only sources of carbon in financing. Insurance underwriting, for example, is another source that some regulators and industry groups recommend considering when assessing and mitigating climate risks. There's no universally accepted quantification methodology for these activities at this time, though there are different approaches that are currently possible and becoming more commonly adopted.[13]

The financial sector plays a large, but quiet, role in the emissions of other companies known as 'financed emissions', a subset of Scope 3. This financing, reflecting billions of dollars on balance sheets, makes the operations of other companies possible. The resulting emissions, if excluded from reporting, can be seen as a misrepresentation of a financial services company's role and responsibility in the environment's current state – a fact that is increasingly in focus for providers of capital and their regulators (such as APRA), as it affects both maintaining a social licence and exposure to physical and transitions risk of climate change.

With data challenges surrounding Scope 3 (not all companies in a value chain able to provide the necessary data), and a lead time of 2-6 months to prepare a Scope 3 inventory, companies should begin examining the quantum of Scope 3 to their footprint, and whether their net zero target does or should include this category.

Climate change: Science-Based and Net Zero Targets

With climate change strategy development and risk management entering a more advanced stage, it is becoming common for companies to establish climate targets. However, due to differences in terminology (such as ‘net zero’, ‘carbon neutral’, or ‘carbon positive’), which are often used interchangeably, and high diversity of the included emissions sources (including or excluding Scope 3 discussed above) coupled with climate target details often in the fine print, the clarity around the ambition level and achievement of climate change targets, strategies and actions has been hard to establish. To remediate that, credibility is best achieved through transparency and, where possible, accreditation of targets disclosed.

The Science-based Targets initiative (SBTi) – a partnership of UN Global Compact, World Resources Institute and the World Wide Fund for Nature – validates a company’s climate target, and has significantly grown in popularity (submissions increased 150%[14] in the lead up to COP26 in 2021 compared to the same time in the previous year) and this is a trend we expect to see continue throughout 2022.

As the popularity of establishing a climate target is expected to continue this year, and with the SBT’s release at the end of 2021 of the “Net Zero Standard”, any target set should follow similar principles in order to have credibility in the market.

Critical principles to be considered include, but are not limited to:

Scopes: Scope 1, 2 and where material (>40% of total emissions) Scope 3 must be included – Scope 3 represents 65–95% of most companies’ broader carbon impact[15].

Target setting and reporting: Targets are established over time intervals and reported publicly on an annual basis.

Offsets: Offsets are excluded from any progress towards emissions targets – with ‘less net, more zero’[16] becoming the focus, particularly as offsets face criticism around validity and ongoing accuracy in the event of natural disasters.

Similar to Scope 3 emissions, establishing an SBT is time-intensive, necessitating the establishment of relationships with a value chain (from suppliers to investments) such that all relevant parties are engaged to ensure a company can reach its climate goals. Further, with climate risk being a form of investment risk, a clear SBT can help manage and minimise the exposure of a financial institution (for which there is discrete guidance[17]).

Activity in Australia: Regulator focus on risk management and ESG credibility

While globally often considered a country taking minimal action, last year Australia took the crown for climate change litigation per capita more than any other nation[18]. Cases in Australia have been wide ranging from banks being challenged on appropriateness of funding and their alignment with public commitments on climate change, to companies in the fossil fuel sector being challenged for potential greenwashing claims, as well as litigation against government bodies covering expansive issues from disclosure to environmental approvals.[19] With ESG related litigation cases increasing, it is a serious transition risk equally for companies and investors requiring a close look at the robustness (or lack thereof) of commitments, strategies and disclosures.

Regulators, notably APRA, are beginning to take meaningful and specific action. CPG 229[20] Climate Change Financial Risks was released by APRA – affecting banks, insurers and superannuation trustees – and, while it clearly stated the guide did not impose new requirements in relation to climate risks, it was clear this was only the case because APRA's existing risk management and governance requirements should result in the consideration and management of climate risks. APRA has also undertaken a Climate Vulnerability Assessment (CVA) of Australian banks, with results to be released this year, and has flagged it will consider extending the CVA to include the insurance and superannuation sectors.

ASIC[21] has made a series of statements about greenwashing and, in October last year, stated it was reviewing ESG-focused financial products to understand how they're offered to investors. Depending on behaviour identified, ASIC will consider action ranging from engagement to enforcement. ASIC has also noted that approaches by international regulators will be monitored, and in September last year themselves took action against 'net zero' statements in offering documents[22]. Recent comments from ASIC Chair reiterate the focus on ESG "...given the number of companies producing detailed climate-related disclosures in response to market expectations, [ASIC] would be "following developments closely... alongside peer regulators" and that "it is important for directors to adopt a proactive approach as developments unfold".

These above underscore the need for companies to be ready and able to prepare climate-related statements that are both credible and all-inclusive to ensure that actions by a company can withstand any legal and regulatory exposure and meet critical stakeholder expectations.

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Endnotes

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