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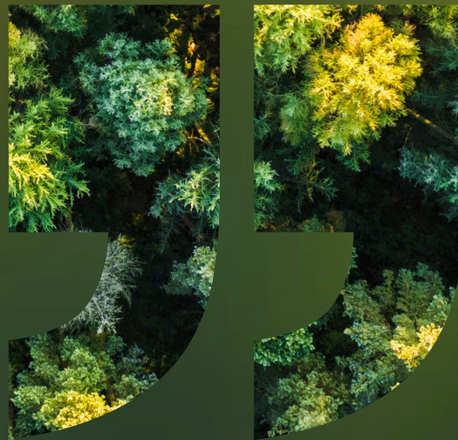
ESG: TRENDS TO WATCH IN 2022



— THOUGHT LEADERSHIP

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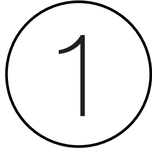
ESG: TRENDS TO WATCH IN 2022

Environmental, social and governance considerations are now mainstream and have an impact on all businesses, globally. We explore the ESG trends that we think will help shape the year ahead.



Regulation – more but different?

We expect to see ESG-related regulation increase this year across all regions. The focus will remain on disclosure and reporting requirements, but with a developing trend towards "double materiality", requiring businesses not only to consider ESG risks to their businesses but also to report on the risks their activities might pose to people and the planet. Double materiality is clearly on the minds of US policymakers, with the Office of the Comptroller of the Currency recently announcing draft principles requiring large US banks to consider and incorporate climate-related risks in their governance frameworks and risk management strategies. Similar prudential requirements on banks are already in place in the UK and the EU. In the UK, consultations are underway on sustainability disclosure requirements that will apply to companies, financial services firms, asset managers and asset owners, including requirements to report on the sustainability impact of investment products as well as their financial risks and opportunities. Issuers with securities listed on the Singapore Exchange are also amongst the latest to be required to provide climate-related disclosures based on Task Force on Climate-related Financial Disclosures (TCFD) recommendations.

We also expect to see moves to impose mandatory due diligence obligations on businesses in relation to human rights and environmental risks in their businesses and supply chains; for example, the European Commission's potentially ground-breaking if long-awaited draft legislation on the topic, which is imminent.

Other examples of ESG legal developments in the pipeline will have a narrower focus and include the European Commission's proposal for a regulation on deforestation-free products, matched by the UK's recent consultation on the implementation of due diligence requirements on "forest risk commodities". Meanwhile, a long-standing international focus on forced labour risk in global supply chains is meeting differing responses through measures such as the Dutch legislation on child labour due diligence and the Uyghur Forced Labor Prevention Act recently passed in the US. With support already from governments such as Belgium, this year may also see a rise in demand for "ecocide" to be recognised as a fifth crime against humanity and under the jurisdiction of the International Criminal Court. Environmental crime has already attracted attention within the anti-money laundering community: an indication (alongside areas such as modern slavery) that ESG issues are infiltrating all levels of banks' risk management.

A point of concern is that, increasingly, international businesses will find themselves grappling with a patchwork of different standards and obligations across regions. For this reason, many global businesses are recognising that they need to approach governance and compliance with ESG standards holistically, avoiding a plethora of separate policies and processes each designed only to address a particular regulatory requirement.

Sustainable finance – growth in market share and ambition

Sustainability-linked loans and bonds have become mainstream, typically including a discount and/or premium on interest based on satisfying ESG-linked Key Performance Indicators (KPIs). Such products appear more popular than "transition finance" labels, and have been embraced by both low and high-carbon emitters. This year, we can expect to see their continuing and increasing use, as businesses focus on their sustainability policies and objectives. There is a sharp focus on ensuring that the KPIs

and other terms of sustainable finance products are (amongst other things) relevant, measurable and sufficiently ambitious in relation to the relevant business, and can be benchmarked. We also expect to see an increasingly sophisticated and consistent approach to setting Specific Performance Targets (SPTs) and KPIs as market knowledge builds and the strategies of businesses in relation to sustainability become more developed. Sustainability-linked finance has the benefit of flexibility in the choice of KPIs, and we expect to see an increase in biodiversity-related KPIs in 2022, particularly as we approach the second phase of the Biodiversity COP, to be held in Kunming, China in April 2022.

External verification of compliance with KPIs included in sustainable finance products (as opposed to internal verification only) is now a regular feature, and there is a push in some jurisdictions (including the EU) to have ever stricter standards and verification for those products being sold as sustainable. We can expect some deals to encounter criticism as the market expectations and standards rise, but investor demand will continue to drive growth.

The development of carbon market structures

At COP26, agreement was reached on key elements of the Paris Agreement Article 6 Rulebook for a new global carbon market mechanism. This allows credits from carbon reduction projects in one signatory state to be used to satisfy another state's carbon reduction commitments (or Nationally Determined Contributions). A further mechanism was created to allow bilateral arrangements (so-called co-operative approaches) to achieve a similar end. Although the processes to finalise the rules continue, 2022 will see signatory states begin to consider how they will participate in these Article 6 mechanisms. Will developing countries allow credits from domestic carbon projects to be traded internationally, or will they wish to retain more control to use such credits for satisfying their own commitments? Will they want to control voluntary markets more closely and divert credits into the regulatory markets? Will developed countries risk claims about the integrity of their climate commitments by accepting international credits to help satisfy their Paris Agreement commitments or will they rely solely on domestic carbon reductions? More clarity may also emerge over the extent to which the Article 6 Rulebook could apply to the voluntary markets – this may help address some of the concerns evident in the voluntary carbon markets over issues such as double counting of credits (one of the issues the new Integrity Council for the voluntary carbon market is currently considering). Development of cross-border carbon markets is also dependent on additional clarity as to the legal nature of carbon credits, the applicability of financial regulation frameworks and the accounting treatment of carbon credits, topics that the International Swaps and Derivatives Association (ISDA) and the UK VCM Forum, amongst other organisations, are considering.

Increasing regulatory, stakeholder and societal pressure to reduce emissions in all sectors is likely to continue in 2022, in particular with the deepening of nations' carbon reduction commitments under the Paris Agreement. The growing trend of companies setting net zero and other climate reduction targets is likely to lead to a major increase in activity in the voluntary carbon markets and rises in the price of voluntary carbon credits, as the supply of carbon credits fails to keep up with demand from corporate offsetters. Companies will increasingly look to invest in, or finance, projects to secure a steady supply of reputable credits, whilst others will develop trading platforms. The UK VCM Forum will continue to push to develop a carbon exchange based in London and CIX will seek a similar exchange in Singapore.

Last year saw a proposal from the EU to protect the carbon reduction efforts of EU industries from cheaper carbon-intensive imports. This would establish a Carbon Border Adjustment Mechanism (CBAM), broadly applying the EU carbon price to imports of certain goods (for example, steel and aluminium) from countries where corresponding carbon reduction efforts have not been made, beginning in 2026. This proposal has been controversial from the beginning – a number of countries have already criticised it as discriminatory and contrary to WTO rules, whereas others

complain that the proposals do not go far enough and should include more types of goods, and come into force earlier. Irrespective of where the proposals end up, the CBAM promises to be costly and administratively burdensome to importers and overseas producers of relevant products at least in the short to medium term. In 2022, the direction of the proposal is likely to become clearer as it makes its way through the legislative process. Other jurisdictions, including the US and the UK, are also considering CBAM mechanisms, and 2022 will likely see more clarity on those plans as well and on how they might form links to an EU mechanism.

The challenges of a Just Transition

The Glasgow Climate Pact, agreed at COP26, emphasised the need for a just transition, putting people at the centre as the world transitions to a sustainable future. In 2022, we can expect increased challenges around the impact of the transition on people, both from the perspective of states and the businesses supporting the transition through investment, innovation and finance.

These challenges include an appreciation of the impact of the transition to a green economy on jobs and livelihoods, access to finance, reskilling of existing workforces, and more. How can the transition be achieved in an inclusive way that takes account of the impacts on the most vulnerable? Alongside governments and public sector institutions that will implement high-level policies, there is a vital role for the private sector, in particular, financiers, to support economic diversification in regions dependent on fossil fuel. Financiers and businesses contributing to the transition will need to develop and implement policies and processes that address both the opportunities and risks to people, if a just transition is to be achieved. Recognising the need to support vulnerable communities (e.g., reskilling costs), even in the absence of a direct revenue stream requires innovative and bespoke solutions. These solutions may also rely on blending finance with the public sector to fund support for these vulnerable communities. Nuanced considerations such as these create both an opportunity to create value and to ensure that, in the spirit of the SDGs, nobody is left behind. This year will hopefully see organisations being encouraged and incentivised to create and adapt financing models that are aligned with a just transition.

ESG litigation – the shifts from governments to businesses

ESG litigation is already a real risk across sectors: this trend is set to continue with several areas of potential exposure for businesses across a wider range of sectors now more pronounced.

It is becoming increasingly challenging for businesses to remain abreast of the emerging trends. In some jurisdictions, it is virtually impossible to eliminate the possibility of being sued, but liability risk should be more manageable if businesses stay abreast of the Achilles heels of legal risk.

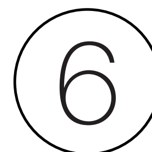
Climate change litigation is one of the main tools within the strategic playbook of activist groups. It will increase in prominence in 2022. NGOs can be expected to make the most of the 2021 Shell decision in the Hague District Court which found that *Shell* owed a legal duty to reduce its emissions (including its scope 3 emissions, i.e., those associated with its value chain). Milieudefensie, a lead Claimant in the case, contacted 29 Dutch corporates in January 2022 to demand they produce climate change plans by 15 April. By stressing a "preference" for dialogue, the letters signal that absent such dialogue, "legal battles" (the term employed in the letter) may ensue.

While *Shell* remains a case to follow closely as it goes through the Dutch appeal process (with a decision unlikely to emerge during 2022), other cases to watch include the several claims by NGOs in Germany against the automotive manufacturers BMW, Mercedes and Volkswagen, as well as against the energy company Wintershall, before various civil courts to prohibit tailpipe emissions from 2030.

And in Italy, the case of *Alcantara Spa vs Miko Srl* saw the first example of ESG litigation between corporates for alleged greenwashing being challenged as anti-competitive. Significantly, this highlights the shift toward increased scrutiny of disclosure obligations not just by regulators and NGOs but also by competitors. This will be equally applicable to possible challenge on net zero commitments and pathways, and on "socialwashing". In parallel, businesses continue to rely on arbitration proceedings under the Energy Charter Treaty to protect their energy investments, including against State measure negatively affecting their renewable energy projects in breach of public international law. A reform process of the Treaty is under way, with some NGOs and politicians demanding that the Treaty should be terminated or limited in scope.

On human rights and social litigation, claims continue to be brought against corporates, seeking accountability for human rights-related harms. The claims affect corporates from all sectors. In December 2021, for example, in the tech space, a US class action complaint has been lodged against Facebook (now called Meta) on behalf of Rohingya refugees before the Superior Court in San Francisco. The allegations relate to the introduction of the company into Burma in 2011. The case, brought on the basis of strict product liability and negligence includes claims that Facebook negligently designed its algorithm which prioritised and failed to remove divisive and harmful anti-Rohingya content from fake accounts, thereby radicalising users in Burma and resulting in the proliferation and intensification of hate speech, misinformation and conspiracy theories. The factual issues raised in the case are mirrored in a specific complaint brought before the Irish National Contact Point for the OECD Guidelines for Multinational Enterprises. This reflects a growing trend to use multiple judicial and non-judicial avenues to seek corporate accountability for human rights harms.

Investment and infratech



2022 will be a game changer for reimagining how energy transition can be achieved through the integration of technology with infrastructure. The resilience of critical infrastructure is a priority for governments across the world as they look to "build back better" from the global pandemic and prepare strategies to achieve their climate targets. The integration of technologies such as blockchain and other distributed ledger technologies (DLTs) with infrastructure will be crucial. For example, the increased use of asset tokenisation (the conversion of hard infrastructure assets such as buildings or power stations into digital assets through the use of DLT-based tokens), may unlock new sources of finance (particularly for projects in middle and low-income countries) which in turn could support sustainable development.

Smart infrastructure (such as smart grids, smart cities, roads, ports and power distribution systems) is increasingly being used to improve performance and efficiencies. But in 2022 this will be taken to the next level as companies start to reimagine how to use robots to perform tasks for them in any location through metaverse technology. For example, immersive virtual reality environments could enable planned and unplanned maintenance in nuclear power plants or remote offshore wind farms through robot avatars, regardless of the real-world location of personnel. To integrate technology with infrastructure, we will see continued investment in autonomous vehicles, data centres and technologies such as 5G and the cloud, which has become an integral part of IT systems worldwide.

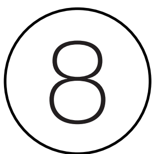
We will also see an increased focus by stakeholders on the ESG implications of Infratech – for example, the excessive energy consumption of blockchain validation processes and the electronic hazardous waste they produce. There will also be greater attention paid to the use of sensitive data and personal information that can be a target for espionage, sabotage and foreign interference, leading to increased scrutiny by governments on foreign investments in relation to these transactions. Governance arrangements associated with the decentralisation of infrastructure systems will also come under the spotlight, with the collective responsibility of participants in such systems aligning with the increasing awareness of sustainability.

The rise of employee and workplace activism

There will be more focus on the 'S' in ESG in 2022, following COVID-19 and other significant social campaigns globally, to create a positive workplace culture, but a failure to navigate employee-stakeholder issues may create the risk of employee litigation.

The ability of employers to secure talent will be linked with employee well-being initiatives, diverse recruitment and upskilling the existing workforce (including green jobs, or to be environmentally compliant). Remote or more flexible working will need to be taken into account as employers continue to consider retention and future (green) workplaces, finding a fair balance between employees' expectations and companies' interests. Stock exchange and regulatory developments, plus external stakeholder intervention and employee expectations will increasingly impose requirements for a breadth of diversity credentials, both at and below board level. There will also be an increased need to update data privacy governance frameworks to manage access to broader DE&I Data. Firms will increasingly explore AI for recruitment and will in doing so need to navigate ethical and bias issues and put in place appropriate frameworks to manage such issues.

Board and workplace culture and ethics will be subject to greater scrutiny, with pressure to ensure that the voice of the employee is heard and appropriate action is taken: whether through enhanced whistle-blowing channels, increased unionisation, ESG outcome-based remuneration and employment practices, or the undertaking of ESG investigations. Employee action is likely not just to focus on employees' own rights (for example, freedom from harassment), but also on their employers' position and actions on climate and sustainability.



COP27 – the work starts now

COP27 will take place in Sharm el-Sheikh, Egypt in November, but there is a huge amount of heavy lifting to be done ahead of the conference. UN Secretary General António Guterres, says: "It's time to go into emergency mode, or our chance of reaching net zero will itself be zero." At COP26 in Glasgow, all countries were asked to strengthen their emission reduction targets in line with 1.5°C by the end of this year, but that is unlikely to happen – China, Australia and Indonesia did not increase their targets in Glasgow, and Mexico and Brazil reduced the pledges they made under the Paris Agreement in 2015. However, amongst other things, some progress was made with commitments to end deforestation, to mobilise private finance and to reduce methane emissions. And it seems inevitable that COP27 will see blame being apportioned for promised funding having failed to materialise.

COP26 was described as the "business" COP when corporates, investors and financial institutions pledged to make a difference. Businesses attending COP27 will need to demonstrate progress in upholding those pledges or face accusations of "greenwashing". COP27 is expected to be the "Africa COP," where the focus shifts to the impact that climate change will have on the African continent and sustainable development. African countries contribute just 4% to global emissions, but will be amongst the worst hit by drought, extreme temperatures and coastal flooding. Adapting to these conditions is likely to be a priority for the conference, as is the urgent need for climate finance, the impact of climate on food security, and the role Africa can play in producing renewable energy. There are also likely to be further attempts made to secure funds to compensate poor countries for loss and damage caused by climate change.

And finally, we anticipate that the increasing recognition of the interconnectedness of climate emergency and the biodiversity crisis will also feature in initiatives and proposed commitments being developed for launch in Sharm el-Sheikh.

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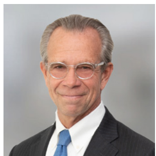

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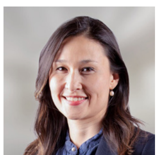

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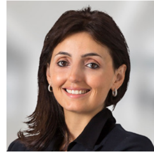

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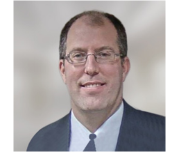

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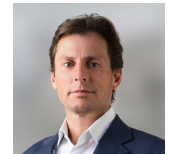

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C H A N C E

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