Capital Markets

Sustainable Finance Group

Sustainability Matters

Environmental, Social and Governance (ESG) Key Themes for 2022

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INTRODUCTION

In our year-ahead outlook, the RBC Capital Markets' Sustainable Finance Group provides an overview of three key themes that we believe will define progress on ESG matters in 2022. This year we consider pathways to net-zero, a coming of age for carbon markets, and the sustainable debt market as an enabler of corporate diversity and inclusion efforts.

Key Themes for 2022

1. **Pathways to Net-Zero Come into Focus:** Given the movement towards standardization across corporate net-zero targets, we believe that 2022 will be a defining year when the discussion evolves from corporate pledges to well-defined transition plans.

2. **A Coming of Age for Carbon Markets:** Climate commitments will bring carbon markets to the forefront in 2022, both in terms of their ability to accelerate the global transition to net-zero as well as growing scrutiny on effectiveness and transparency.

3. **Advancing Diversity and Inclusion through the Sustainable Debt Market:** In 2022, the sustainable debt market will continue to flourish as an avenue to advance diversity and inclusion efforts alongside climate goals.

PATHWAYS TO NET-ZERO COME INTO FOCUS

Last year in our "ESG Themes for 2021" report, we highlighted the rise of corporate sustainability targets, and particularly those focused on climate, as a key theme for the year ahead. As anticipated, climate target-setting gained strong momentum over the course of 2021, and especially so during the lead-up to COP26. As of early January 2022, the Net Zero Tracker, a global database capturing net-zero pledges from a variety of entities, noted that approximately one-third of the 2,000 largest publicly traded companies globally have set a net-zero target.[1]

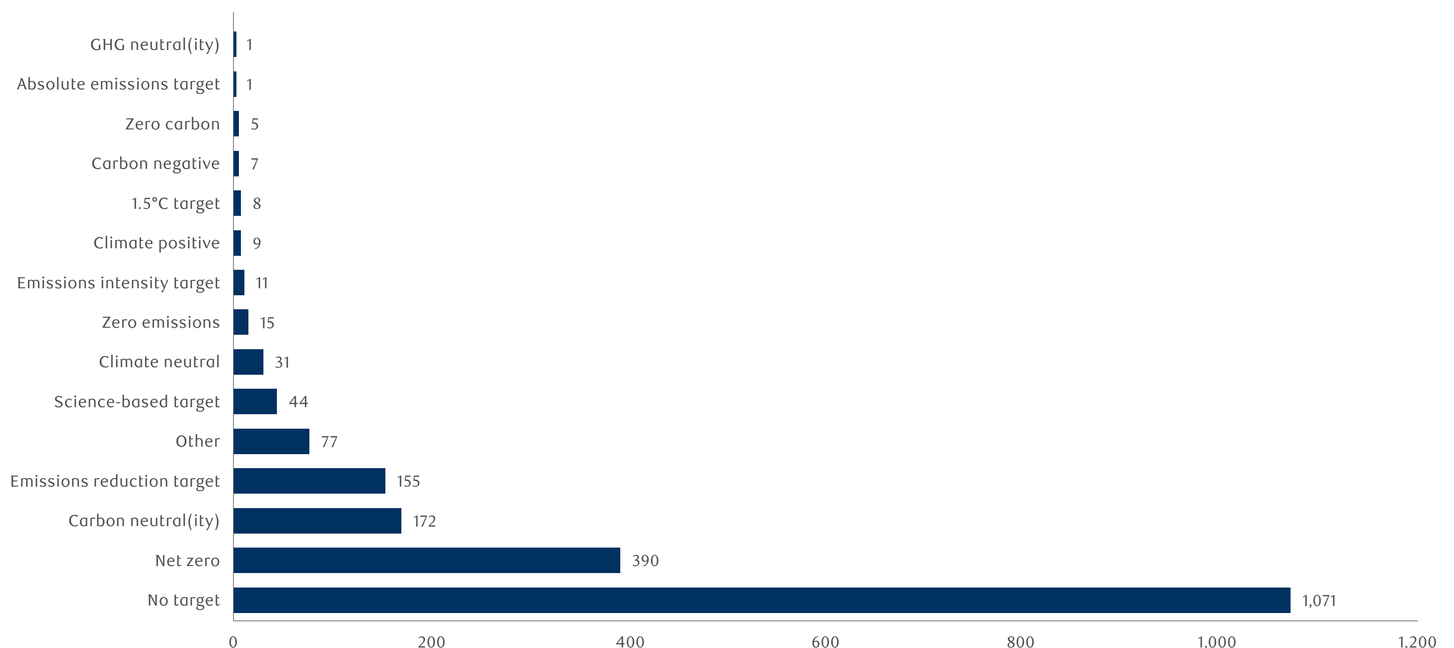
A lack of standardization is one of the biggest challenges associated with the proliferation of net-zero targets. Currently, net-zero targets are self-defined and differ across a number of key parameters, including timeframe, emissions scope coverage, and coverage of specific greenhouse gases (GHGs). Among the 682 companies included in the Net Zero Tracker dataset, 390 have set an explicit "net zero" target, while the remainder have set targets tagged as "climate positive", "climate neutral", and "carbon negative", among others – all of which can have different meanings.[2] Some companies have set targets that address Scope 1, 2, and 3 emissions, while others have a more limited scope.

Efforts to enhance the integrity and consistency of net-zero targets are growing. At COP26, citing "a deficit of credibility and a surplus of confusion over emissions reductions and net zero targets", U.N. Secretary-General António Guterres announced the creation of a new expert group to analyze net-zero commitments from non-state actors.[3] Prior to COP26, the Science-Based Targets initiative (SBTi) launched the Corporate Net-Zero Standard, the world's first framework for corporate net-zero target setting in line with climate science. The Standard provides companies with guidance, criteria, and recommendations to set science-based net-zero targets in line with limiting global temperature rise to 1.5°C.[4] Given the movement towards standardization across net-zero targets, we believe that 2022 will be the year where the discussion evolves beyond target-setting and towards the articulation of transition plans to achieve these goals.

In the year ahead, we anticipate expectations and scrutiny to further intensify as stakeholders seek decision-useful information on corporate transition plans to achieve stated climate commitments. Transition plans will vary across industries and regions, but at a high level, we anticipate seeing increased disclosure on the tactical actions required to achieve both interim and long-term climate goals, including changes to technology and product mix, cross-sector collaboration and supply chain initiatives, and R&D spending.[5]

A number of recent initiatives led by the financial sector, including the Climate Action 100+, the Task Force on Climate-related Financial

CLIMATE TARGET TERMINOLOGY VARIES ACROSS THE 2,000 LARGEST PUBLICLY TRADED COMPANIES GLOBALLY



Source: Net Zero Tracker, January 2022.

Disclosures (TCFD), and the Glasgow Financial Alliance for Net-Zero (GFANZ) are building a foundation to help support corporates in the development of such plans.

- The Climate Action 100+, an investor group focused on engaging with the world's heaviest corporate GHG emitters, has developed a framework to assess corporate progress against net-zero targets and intends to publish a series of sectoral decarbonization strategies to help map the transition for a number of key sectors.[6]
- The TCFD recently issued guidance on the key disclosure elements recommended for corporates to include in their transition plans, such as planned changes to businesses, strategy, and capital expenditures.[7]
- The GFANZ, a global coalition of over 450 financial firms committed to using science-based guidelines to achieve net-zero emissions by 2050, is focused on advancing seven key areas critical to the net zero transition. The GFANZ's seven workstreams are focused on turning commitments into actionable initiatives and include developing sectoral pathways to reach net-zero, transition plans for the real economy, and driving convergence around best practices for financial institutions' net-zero transition plans.[8]

We expect that the movement towards increased standardization in target-setting and the growing focus on transition planning will translate into opportunities for new sustainable debt issuance in 2022 as many of the companies and financial institutions that have committed to achieving net-zero will set interim science-based targets to guide their actions in the intervening years between now and 2050. An increase in ambitious, science-based GHG emissions reduction targets will provide companies with new opportunities to align their climate strategy and financing through sustainability-linked debt instruments. In addition, as corporates explore future capital expenditure plans to support the achievement of net-zero targets, they may also increasingly look to the green, sustainable, or transition bond markets as sources of funding for eligible projects.

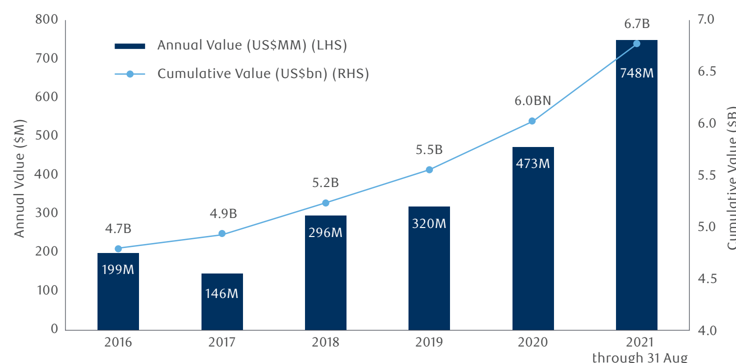
A COMING OF AGE FOR CARBON MARKETS

As the number of companies setting net-zero emissions targets continues to grow[9], so too will the use of carbon offsets to reach these commitments. Best practice typically reserves offsets for hard to abate residual emissions; however, companies trying to reach ESG targets quickly will increasingly turn to offsets as deeper decarbonization strategies take time to ramp up. In 2022, we expect this trend to bring carbon markets to the forefront, both in terms of their ability to accelerate the world's transition to net-zero, while also facing increasing skepticism and scrutiny on their efficacy in reducing GHGs.

Carbon markets are comprised of both compliance markets, which are regulated by an international, national or regional government or body, and voluntary carbon markets (VCMs), a fragmented system of issuers, verifiers, certifiers, exchanges and buyers which allow entities or individuals to purchase carbon offsets for their own voluntary use. While compliance carbon markets, such as the EU Emissions Trading Scheme, have largely escaped criticism due to their enhanced controls and governance, they currently cover less than 20% of global emissions.[10] Until more of the global economy is covered by a carbon price or compliance market, most companies will continue to rely on VCMs. Despite these headwinds, VCMs have seen rapid growth over the past few years and could reach between $100bn by 2030[11], up from under $500MM in 2020.[12,13]

Carbon offsets generally fall within two categories. Removals, which help sequester GHGs from the atmosphere and include projects like reforestation or direct air carbon capture; and avoidance, which reduce emissions by preventing them from entering the atmosphere in the first place and include projects like conserving an old growth forest or building a solar plant. Prices for offsets vary based on a large range of criteria such as the category, vintage, verifier, and

MARKET SIZE BY TRADED VALUE OF VOLUNTARY CARBON OFFSETS



Source: Ecosystem Marketplace, a Forest Trends Initiative (2021)

geography, and result in a wide range of prices anywhere from $1-$1000+ per offset. Adding to the complexity are various ESG standards and commitments which may have different eligibility requirements for the use of offsets in meeting sustainability targets. For example, the Science Based Targets Initiative (SBTi) Net Zero Standard allows an organization to only meet up to 5-10% of their emissions reductions with offsets, and those offsets also have to be sourced from removal-based projects.[14]

To enhance the credibility of voluntary offsets and support the growth of VCMs, we expect 2022 to yield advancements in standards for measurement, reporting and verification. These efforts are being led by the Taskforce on Scaling Voluntary Carbon Markets (TSVCM) and the Voluntary Carbon Markets Integrity Initiative (VCMI). However, the most influential development may turn out to be the creation of the rulebook for Article 6 of the Paris Agreement which was formally agreed to at COP26. Article 6 sets the rules for how countries can trade emissions with each other as a means to reach their national greenhouse gas emission reduction targets.[15] While VCMs aren't covered by Article 6, it lays the groundwork for creating a more transparent and credible global carbon market, and we expect VCMs to consider or begin implementing parts of the Article 6 rulebook in the next year.

Further innovations we expect to see this year include the growth of nascent offset types like regenerative agriculture and direct air capture, new financial structures and uses of offsets such as neutralizing carbon emissions in investment products. As companies think about the role of offsets in their sustainability strategies, we recommend a portfolio approach and selecting offsets that come from projects that align with their core business operations, support their corporate values, and resonate with their stakeholders. For additional support in navigating the rapidly evolving carbon markets universe, RBC Capital Markets offers extensive expertise and full capabilities in emissions trading across both compliance and VCMs.

ADVANCING DIVERSITY AND INCLUSION (D&I) THROUGH THE SUSTAINABLE DEBT MARKET

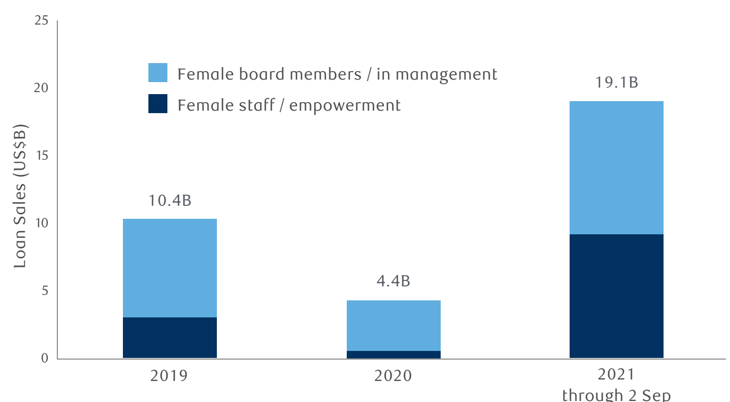
In addition to corporate efforts, a growing number of investors are increasingly seeking opportunities to use their capital to reduce societal inequalities.[16] Given investor appetite, and taking into consideration the disproportionate impact of the COVID-19 pandemic on racialized communities, women, and transgender and non-binary people[17], we believe that 2022 will be a year where corporates and investors increasingly employ sustainable debt solutions to advance broader diversity, equity and inclusion objectives.

The sustainable debt market plays an important role in financing progress towards a variety of sustainable development goals, including improved socioeconomic outcomes and reduced inequalities. A growing number of corporates and investors are setting ambitious diversity targets and linking financing structures to the advancement of these objectives through the issuance of sustainability-linked debt.

In 2021, the RBC CM Sustainable Finance Group acted as Sustainability Structuring Agent for the first organization globally to link its financing structure to progress made against its Bloomberg Gender-Equality Index (GEI) score.[18] The Bloomberg GEI score is based on performance across five dimensions: female leadership and talent pipeline, equal pay and gender pay parity, inclusive culture, anti-sexual harassment policies, and pro-women brand.[19] Given that inclusion has historically been challenging to quantify, the incorporation of "inclusive culture" as a pillar in the Bloomberg GEI is an encouraging development that may offer corporates and investors a more meaningful and nuanced metric to capture performance on D&I issues. In 2022, we anticipate that a growing number of companies will set increasingly ambitious diversity targets that incorporate inclusion as a key consideration alongside other important metrics.

By linking interest rates to the achievement of predetermined sustainability performance targets (SPTs), sustainability-linked debt can act as an effective incentive to help companies achieve

LOAN SALES WITH INTEREST RATES LINKED TO BORROWER'S IMPROVEMENT IN GENDER EQUALITY ISSUES



Source: Bloomberg NEF
Note: Based on sustainability-linked loans with metric information disclosed

predefined social objectives. As of September 2021, loan sales with interest rates linked to gender equality targets reached US$19bn, more than quadruple the volume of the previous year.[20] Workforce gender equality goals, and particularly representation of women in management, are currently among the most commonly-used social key performance indicators.[21] Despite this rapid growth, the volume still represents less than one-tenth of the overall sustainability-linked loan market, where environmental metrics remain dominant.[22] Indeed, new voluntary guidelines released by the International Capital Market Association (ICMA) note that investor demand for gender-related sustainable debt is high and exceeds the current supply.[23]

In the year ahead, we anticipate that corporates and investors will increasingly look beyond gender to incorporate a more holistic view of diversity, including racial and ethnic diversity, neurodiversity, and socioeconomic diversity, in sustainable financing frameworks.

The advancement of racial and ethnic diversity continues to be a critical aspect of D&I that has increasingly gained traction as a sustainability-linked KPI in recent years. The emergence of D&I syndicates in the U.S., which are groups of broker-dealer firms owned by diverse groups, is another example of the concerted effort to increase social equity by providing minority- and women-owned broker-dealer firms with an opportunity to demonstrate their capabilities and increase their engagement with a broader group of investor clients.[24] In July 2021, RBC partnered with diverse-owned broker-dealers on its second Green Bond offering. The engagement of diverse broker-dealers in the transaction elevated the US$750 million offering, facilitating allocations into unique pockets of demand and further enhancing distribution.[25]

In addition to racial and ethnic diversity, we have recently observed a number of corporates turning their attention toward enhancing other elements of workplace diversity, including socioeconomic and neurodiversity. In the UK, several large professional services firms recently disclosed targets to increase the proportion of partners from a working-class background, as indicated by parental occupation when the employee was aged 14.[26] A number of financial institutions in Europe have issued social bonds with proceeds allocated to projects in certain postal code areas in order to maximize the socioeconomic impact of investments in health, well-being, and education.[27]

Looking to the year ahead and beyond, we are likely to see both corporates and investors focus on these new aspects of diversity as they look to amplify employee strengths and perspectives. In 2022, we anticipate that the companies that will benefit the most from a diverse workforce will be those that embrace a thoughtful, progressive approach to diversity and devote significant effort to fostering inclusion and a sense of belonging among employees.

CLOSING THOUGHTS

2021 was a year in which commitments to sustainability accelerated, driven by global policy alignment in the lead-up to COP26 and widespread recognition that the private sector plays a fundamental role in addressing transnational challenges such as climate change and societal inequality. We believe that 2022 will be a defining year when the discussion evolves from corporate pledges to the articulation of well-defined transition plans. We anticipate that corporate climate commitments will bring carbon markets to the forefront and expect the sustainable debt market to continue to flourish as an avenue to advance diversity and inclusion efforts alongside climate goals.

At the same time, stakeholder scrutiny of corporate sustainability initiatives has never been higher, underscoring the importance of working with partners who share similar values and priorities. RBC Capital Markets works in collaboration with our clients to help them establish and articulate robust sustainability strategies and transition plans, transact across both compliance and voluntary carbon markets, and structure ambitious and meaningful sustainable finance solutions. Looking ahead, we see 2022 as a year of great promise and tangible progress as corporates and investors alike continue to seize the opportunity that ESG presents.

For more RBC Capital Markets reports, articles and seminars related to ESG, go to **https://www.rbccm.com/en/insights/esg.page**

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