Capital
Markets

Sustainable
Finance Group

Sustainability Matters

Environmental, Social and Governance (ESG) Key Themes for 2023

JANUARY 2023

INTRODUCTION

January 2023 marks four years since RBC Capital Markets launched the Sustainable Finance Group and we have witnessed considerable market growth and evolution in the years following the establishment of our team. Our annual year-ahead piece has captured these evolving trends over the years, including the growth of sustainability-linked loans, the rise of corporate ESG target-setting, and a coming of age for carbon markets. In 2022, we observed a notable pivot in the sustainable finance market, which we did not anticipate but welcome as a sign of maturation and integrity. These changes have informed our approach to identifying the three key themes that we believe will shape progress on ESG matters in the year ahead.

Key Themes for 2023

1. **The Evolution of the Sustainability Disclosure Landscape:** We anticipate that a global baseline for sustainability disclosures, expected to be finalized by the International Sustainability Standards Board (ISSB) in 2023, will bring about a renewed emphasis on the concept of financial materiality and the interplay between sustainability and financial value creation.

2. **A Great Reset for ESG Integration and Sustainable Finance:** As market participants become more sophisticated and regulatory frameworks become increasingly stringent with regards to what qualifies as a sustainable investment, we believe that heightened attention to quality and integrity will help temper greenwashing concerns and drive further innovation in the sustainable finance market.

3. **A Growing Market for Transition Finance:** The rise of energy independence as a critical national security priority, paired with growing recognition that some of the most impactful opportunities for decarbonization and value creation can be found within the highest-emitting sectors of the economy, will lead to an increased focus on projects that do not currently align with a pure “green” framework but that ultimately will be instrumental in helping to reach net-zero by 2050.

THE EVOLUTION OF THE SUSTAINABILITY DISCLOSURE LANDSCAPE

The widespread adoption of corporate sustainability disclosure over the past decade was accompanied by concurrent growth in the development of reporting frameworks and standards, which led to an ecosystem that was often described as an "alphabet soup" of acronyms. In response to investor demands for high-quality, transparent, reliable, and comparable reporting, the IFRS Foundation Trustees established the International Sustainability Standards Board (ISSB) in November 2021. Since its launch, and over the course of 2022, the ISSB has built on the work of existing investor-focused reporting initiatives, published two draft standards for stakeholder feedback, and grounded its standard-setting work in the relationship between sustainability and financial value creation. In December 2022, the ISSB agreed to describe "sustainability" in its disclosure standards as "the ability for a company to sustainably maintain resources and relationships with and manage its dependencies and impacts within its whole business ecosystem over the short, medium and long term."[1]

A Renewed Emphasis on Financial Materiality

We expect that 2023 will bring renewed emphasis to the concept of financial materiality, described in the investor-focused SASB Standards Implementation Primer, which is now part of the IFRS Foundation's guidance, as the sustainability factors that are most likely to materially impact the financial condition or operating performance of companies in a given industry.[2] With the ISSB's conceptualization of sustainability drawing from the multi-stakeholder-focused Integrated Reporting Framework, and the principle of "double materiality" now embedded in European sustainability reporting standards, we anticipate that the concept of financial materiality may take on a more expansive definition in the year ahead while still retaining a clear focus on financial value creation.

A BROADENING DEFINITION OF MATERIALITY

Traditional Financial Materiality (i.e. "Single Materiality")

Double Materiality

Source: RIA Canada, 2022. Double, Sesqui, and "Regular" Materiality: Sustainability Disclosures and Different World Views - Responsible Investment Association (riacanada.ca)

Final ISSB standards, which are expected in 2023, will provide issuers with a common framework to disclose financially material sustainability information and will provide investors with comparable information to assess peer companies more easily. We also anticipate that regulators in some jurisdictions will move toward enshrining elements of the forthcoming ISSB standards in mandatory reporting requirements, much as we have seen for climate-focused financial disclosures aligned with the Task Force on Climate-Related Financial Disclosures (TCFD) framework.[3]

A Growing Focus on Scope 3, Nature and Biodiversity, and Human Capital Disclosures

There are three sustainability disclosure themes that that we believe will come into focus in the year ahead: Scope 3 GHG emissions, nature and biodiversity, and human capital. Until recently, companies largely focused on emissions from their own operations under Scope 1 and Scope 2 of the GHG Protocol. In 2022, we saw Scope 3 GHG emissions, the indirect upstream and downstream emissions that occur within a company's value chain, attract increased attention, with the ISSB voting unanimously to require company disclosures on Scope 3 GHG emissions when material for a company, albeit with relief provisions to help companies apply these new requirements.[4]

There are a number of challenges associated with calculating Scope 3 GHG emissions, including data collection and methodology issues, and a recent progress report published by the TCFD noted that the proportion of companies disclosing Scope 3 GHG emissions remains significantly lower than the proportion disclosing Scope 1 and 2 GHG emissions.[5] In the year ahead, we anticipate that the conversation around Scope 3 GHG emissions will become more nuanced and industry-specific. The GHG Protocol defines fifteen distinct reporting categories of Scope 3 GHG emissions, including purchased goods and services, transportation and distribution, and the use of sold products.[6] With this in mind, we expect climate-focused disclosures to become more granular, enabling corporates to focus on the Scope 3 categories that will drive the highest impact in terms of overall GHG emissions reduction.

The interdependence of climate and nature, which we highlighted in our July 2022 edition of Sustainability Matters, emerged as an important theme last year. The opportunity is tremendous: the World Economic Forum estimates that by the end of this decade, nature-

positive projects and transitions could generate up to US$10.1 trillion in annual business value and create 395 million jobs.[7] A growing focus on nature and biodiversity culminated in a historic agreement at COP15, the UN Convention on Biological Diversity, to adopt a global biodiversity framework to protect ecosystems around the world.[8] The ISSB is currently considering work done by the Taskforce for Nature-related Financial Disclosure (TNFD) on the intersection of climate and biodiversity disclosures in the scoping of research to complement its Climate-related Disclosures Standard.[9] Recognizing the importance of realizing Indigenous peoples' rights to land and resources and their role as stewards of 80% of the world's remaining biodiversity, the ISSB recently appointed a Special Advisor to provide strategic counsel on issues important to Indigenous Peoples.[10,11] We believe that the inclusion of traditional Indigenous knowledge related to the conservation of biodiversity represents one of the most significant and impactful advancements in sustainability disclosure efforts to date. In 2023 and beyond, we expect Indigenous-led conservation initiatives around the world to play a critical role in helping to achieve the goals adopted at COP15 to halt and reverse nature loss, including putting 30% of the planet and 30% of degraded ecosystems under protection by 2030.[12]

As we noted in our October 2022 edition of Sustainability Matters, human capital – a dimension of sustainability that is inclusive of employee health and safety; employee diversity, inclusion, and engagement; and labor practices – is an ESG-related topic that has garnered significant attention from corporates and investors alike in recent years. In 2023, we anticipate that the growing body of research supporting the relationship between good human capital management and financial performance, combined with heightened expectations from institutional investors, will support corporate initiatives and disclosure around a factor that is increasingly recognized as near-universal in terms of its financial materiality. In addition, we anticipate that the human capital considerations related to the transition to a net-zero economy, and particularly those related to inequality, will gain increasing prominence in the year ahead. These considerations include, among others, fair wages and working conditions, diversity and inclusion initiatives, and efforts to create high-quality employment opportunities for impacted communities.

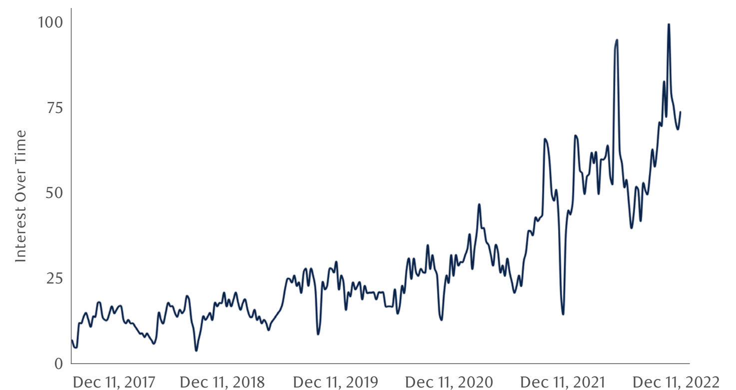
A GREAT RESET FOR ESG INTEGRATION AND SUSTAINABLE FINANCE

In 2022, we saw growing investor, regulatory, and public scrutiny of corporate sustainability commitments and strategies translate into heightened attention to quality and integrity in the sustainable finance market. We expect that an evolving disclosure landscape and a renewed focus on financial materiality and value creation will draw further attention to these issues in the year ahead. As market participants become more sophisticated and regulation becomes increasingly stringent, issuers must hold themselves to a higher standard with respect to the disclosures, frameworks, and structures that support their participation in the sustainable finance market. We have begun to see this play out through heightened scrutiny around greenwashing, reclassification of ESG-labeled funds, and enhanced guidance and transparency in the sustainable debt market.

Greenwashing Scrutiny

The concept of greenwashing – which can be understood as false or misleading claims regarding the environmental credentials of a company, product, or service – continues to draw enhanced scrutiny from a range of stakeholders. We are increasingly seeing the concept of greenwashing extend beyond environmental claims to cover the misrepresentation of companies' purported positive social impacts. According to Google Trends, search interest for "greenwashing" hit a five-year peak in November 2022, with a surge of searches that coincided with the release of a highly-anticipated UN report during COP27 titled *Integrity Matters: Net Zero Commitments by Businesses, Financial Institutions, Cities, and Regions*. The report addressed key concerns around the use of net zero pledges and set out clear

GOOGLE TRENDS: WEB SEARCH INTEREST FOR 'GREENWASHING'



Source: Google Trends (December 17, 2022). Numbers represent search interest relative to the highest point on the chart for the given region and time. A value of 100 is the peak popularity for the term. A value of 50 means that the term is half as popular. Geography: Worldwide. Timeframe: Past 5 Years. Category: All. Search type: Web.

definitions for what it means to be net zero and net zero-aligned, noting the importance of having not only long-term pledges but also short-term science-based targets, detailed transition plans, and capital expenditures aligned with these targets.[13]

The Impact of Regulation on Fund Classification and Flows

Looking ahead to 2023, we anticipate that more stringent regulation with regards to what qualifies as a sustainable investment will act as a tailwind for strengthened quality and integrity in the market. The EU's Sustainable Finance Disclosure Regulation (SFDR), which requires asset managers to classify funds sold in the EU as Article 6, 8, or 9, depending on the fund's sustainability objectives, is having a clear impact on sustainable fund flows. The RBC Capital Markets ESG Equity Strategy team recently noted that Article 8 funds, considered "light green", have seen outflows on a trailing 1-year basis, likely reflecting greenwashing concerns given the broadness of the category.[14] Conversely, Article 9 funds, considered "dark green", have taken in the bulk of net inflows during that same time, reflecting resilient investor demand for the category.[15] The SFDR, which will also require managers to disclose more granular information on their funds' ESG approach, has led to some managers reviewing their funds' classification and downgrading Article 9 products to Article 8, with more expected in the months ahead.[16]

Other jurisdictions – notably, the US and the UK – have also put forth proposals requiring more detailed ESG disclosure by funds and advisors. In the North American market, more stringent definitions around the practice of ESG integration have contributed to a decrease in the total value of sustainable assets under management. The US Forum for Sustainable and Responsible Investment's (US SIF) December 2022 biennial Report on US Sustainable Investing Trends identified US$8.4 trillion in total sustainable investing strategies in the United States, compared to US$17 trillion identified in 2020.[17] This steep decline can be explained by a change in the US SIF's methodology that required fund managers to provide more granular information in order to be included in the tally of sustainable investment assets under management, as well as the impacts of regulatory proposals published by the Securities and Exchange Commission (SEC) focused on preventing misleading fund names and requiring more detailed ESG disclosure by funds and advisors.[18] Following the release of the SEC proposals in 2022, the US SIF observed multiple asset managers reporting a modest to steep decline in ESG AUM in comparison to their responses in previous years, an indication that regulatory pressure is leading to increased prudence around fund labeling.[19] In the year ahead, we anticipate that the estimated baseline of global sustainable assets under management to moderate from previous estimations, reflecting a growing focus on credibility and rigor in the market.

Enhanced Guidance, Transparency, and Innovation in the Sustainable Debt Market

In the sustainable debt market, the growth of sustainability-linked instruments has brought increased stakeholder demand for more guidance. In June 2022, the International Capital Market Association (ICMA) published a selection of new guidance documents, including new definitions for green securitization, updated key performance indicators (KPIs) for sustainability-linked bonds, and new resources for climate transition finance. These resources serve to further support market transparency and integrity, particularly with regard to the selection of industry-specific material KPIs for sustainability-linked debt instruments.[20]

In 2023, we believe enhanced stakeholder scrutiny and additional market guidance will continue to drive confidence in the market and advance product innovation. With Scope 3 GHG emissions rising in importance in terms of measurement and disclosure, we anticipate seeing a growing number of market participants seek to include Scope 3 reduction targets or proxy KPIs in sustainability-linked structures. We also expect guidance related to biodiversity, including ICMA's KPI registry and the recently-published Biodiversity Finance Reference Guide from the International Finance Corporation, to translate into an increased focus on biodiversity within the sustainable debt market. Following discussions at COP15, we may also see a growing focus on creative mechanisms to direct cost savings from sovereign debt restructuring towards conservation, mitigation, and adaptation initiatives. One innovative example is The Nature Conservancy's Blue Bonds for Conservation program, which involves a debt-swap mechanism that channels a portion of savings from debt restructuring into marine conservation efforts. Much like climate, we see nature and biodiversity as financially material to all sectors of the economy, and as a result, see immense potential for issuers to integrate these considerations into their corporate sustainability strategies and use the sustainable finance market as a lever for advancement.

A GROWING MARKET FOR TRANSITION FINANCE

In last year's outlook piece, we anticipated that 2022 would bring about notable progress from net zero pledges to action, with a growing number of corporates articulating detailed transition plans to support climate commitments and GHG emissions reduction targets. As expected, 2022 was a year where many issuers published detailed strategies outlining the initiatives required to achieve their decarbonization commitments. The energy crisis that unfurled following Russia's invasion of Ukraine contributed to what we see as growing pragmatism within the sustainable finance market, particularly with regards to the role of transition finance – specifically, the financing of decarbonization-focused projects that do not currently align with a traditional "green" framework but that ultimately will be instrumental in helping to reach net-zero emissions by 2050. We believe that the following drivers will play an important role in the growth of transition-focused finance: an increasingly supportive regulatory environment, private capital investment, transition-themed use of proceeds and sustainability-linked debt instruments, and further development of voluntary carbon markets.

A Supportive Regulatory Environment

In the year ahead, we anticipate that an increasingly supportive regulatory environment in Europe and North America, paired with growing acknowledgement that some of the most significant opportunities for decarbonization can be found in the highest-emitting sectors, will flow through to the sustainable finance market. The war in Europe fundamentally transformed the global supply and distribution of energy and brought the reality of the "energy trilemma" – the complex interplay of energy security, energy affordability, and environmental sustainability – to the forefront. In North America, energy independence emerged as a national security priority in the aftermath of the Russian invasion, with the passage of the 2022 U.S. Inflation Reduction Act (IRA) serving as a catalyst to pool capital and strengthen incentives for emissions-intensive sectors to invest in pathways to decarbonization.

Private Capital Investment

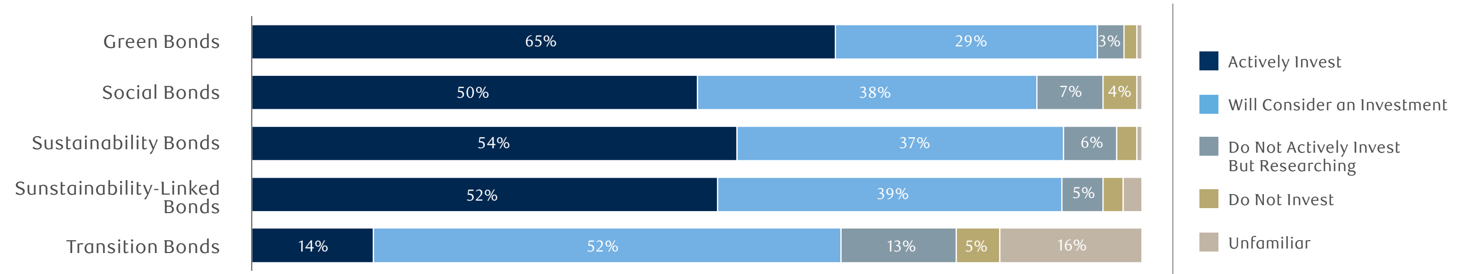
Given the enormity of the capital required for the transition to a net-zero economy – by some estimates, achieving net-zero GHG emissions will require $100 trillion in capital investment – a variety of sources will be needed to finance efforts across all sectors of the economy. Dedicated pools of private capital focused on the energy transition, inclusive of industrial, building, and consumer applications, continue to emerge. We see private equity GPs playing a leading role in capturing opportunities to achieve both value creation and climate objectives by investing in high-quality, emissions-intensive businesses and implementing transition strategies focused on deep decarbonization.

Transition-Themed Use of Proceeds and Sustainability-Linked Debt Instruments

In the sustainable debt market, we believe that the strategic and operational strides that many issuers have made in recent years will position them well to leverage both sustainability-linked and use of proceeds instruments as key enablers of their transition strategies. RBC Capital Markets' 2022 Global ESG Credit Investor Survey, which gathered perspectives from 145 fixed income investors globally, revealed investor preferences and positioning on transition-labelled debt. While 14% of respondents reported that they actively invest in transition bonds today, 65% indicated that they are either considering or researching the product.

We believe that investors' relative unfamiliarity with transition labels combined with limited issuance to date presents an opportunity to increase awareness and potentially fuel the growth

WHICH OF THE FOLLOWING LABELED SUSTAINABLE DEBT PRODUCTS DO YOU PREFER TO INVEST IN?



Source: RBC Capital Markets. 2022 Global ESG Credit Investor Survey.

of transition-themed debt instruments in the future. At the same time, we are seeing many issuers gravitate toward sustainability-linked debt instruments as a way to articulate a bespoke transition story. Sustainability-linked structures also provide issuers with the flexibility to integrate KPIs related to social themes, such as job creation, expenditure on locally-sourced goods and services, and access to essential services – important considerations in the context of working toward an equitable, inclusive, and orderly transition.

Voluntary Carbon Markets

Corporate climate commitments brought voluntary carbon markets (VCMs) to the forefront in 2022, both in terms of their ability to accelerate the global transition to net zero and also in terms of growing scrutiny regarding quality and market integrity. In 2023, efforts to scale VCMs are poised to continue, with both demand- and supply-side integrity initiatives playing a crucial role in driving increased trust and transparency among market participants. In 2023, we anticipate that the critical role of high-quality carbon credits as a source of funding for nature-based solutions, particularly in the Global South, and as a tool to reduce emissions and support biodiversity, mitigation, and adaptation objectives, will become increasingly appreciated by market participants, regulators, and the general public alike.

Transitioning to a net-zero future will require significant investment, and much of this is needed in sectors of the economy that are high-emitting and hard-to-abate. RBC Capital Markets supports clients in these industries on their journey towards a net-zero economy with products, services, and advice, and we believe that there is an important opportunity for high-emitting sectors to access the sustainable finance market to support their decarbonization objectives.

CLOSING THOUGHTS: WHAT'S NEXT FOR SUSTAINABLE FINANCE?

In addition to opportunities within the sustainable debt market, as we look ahead to the 2023, we also see tremendous potential for the continued integration of ESG considerations more broadly across capital markets. While recognizing that a more robust environment for IPO issuance will require a greater degree of geopolitical and macroeconomic stability, once ECM windows re-open, we expect to see a backlog of high-quality companies with robust sustainability credentials come to market. The slowdown in IPO activity in 2022 provided many late-stage private companies with an opportunity to focus on strengthening sustainability strategies and disclosure in preparation for heightened investor expectations. From an M&A perspective, we expect regulatory scrutiny focused on ESG factors, including environmental issues, labor management considerations, and strategic issues related to the ownership of critical minerals crucial to the energy transition, to emerge as an important theme in 2023.

2022 was a year in which we observed the sustainable finance market evolve toward greater maturity, transparency, and integrity. We look forward to continued advancement in 2023, shaped by a renewed emphasis on financial materiality and value creation, a heightened attention to quality across both products and disclosures, and a growing market for transition finance supported by diverse sources of capital.

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

Lindsay Patrick
Managing Director and Head,
Strategic Initiatives & ESG

Sarah Thompson
Managing Director
Sustainable Finance

Moses Choi
Director
Sustainable Finance

Stefano Vitali
Director
Sustainable Finance

Nicola Milne
Director
Sustainable Finance

Gabriela Furtado
Vice President
Sustainable Finance

Brian Hong
Vice President
Sustainable Finance

Dana Hummel
Vice President
Sustainable Finance

Christopher Antony
Vice President
Sustainable Finance

Sarah Moloney
Associate
Sustainable Finance

Justine Nowicki
Associate
Sustainable Finance

Jonah Harding
Analyst
Sustainable Finance

If you have any questions, please reach out to our team: sustainablefinance@rbccm.com

1 IFRS - ISSB describes the concept of sustainability and its articulation with financial value creation, and announces plans to advance work on natural ecosystems and just transition
2 Understanding SASB Standards - SASB
3 2022-TCFD-Status-Report.pdf (bbhub.io)
4 IFRS - ISSB unanimously confirms Scope 3 GHG emissions disclosure requirements with strong application support, among key decisions
5 2022-TCFD-Status-Report.pdf (bbhub.io)
6 Scope 3 Calculation Guidance | Greenhouse Gas Protocol (ghgprotocol.org)
7 New Nature Economy Report II: The Future Of Nature And Business | World Economic Forum (weforum.org)
8 COP15 negotiations reach crucial decision point for global agreement to protect nature - The Globe and Mail
9 IFRS - ISSB describes the concept of sustainability and its articulation with financial value creation, and announces plans to advance work on natural ecosystems and just transition
10 IFRS - ISSB describes the concept of sustainability and its articulation with financial value creation, and announces plans to advance work on natural ecosystems and just transition
11 Microsoft Word - Backgrounder Lands Territories Resources (FINAL).docx
12 COP15 ends with landmark biodiversity agreement (unep.org)
13 high-levelexpertgroupupdate7.pdf (un.org)
14 https://www.rbcinsightresearch.com/ui/main/r/s/bV4SMHA3
15 https://www.rbcinsightresearch.com/ui/main/r/s/bV4SMHA3
16 SFDR Article 8 and Article 9 Funds: Q3 2022 in Review | Morningstar
17 Trends 2022 Executive Summary.pdf (ussif.org), US SIF Trends Report 2020 Executive Summary.pdf
18 https://www.ussif.org//Files/Trends/2022/Trends%202022%20Executive%20Summary.pdf
19 https://www.ussif.org//Files/Trends/2022/Trends%202022%20Executive%20Summary.pdf
20 The Principles announce key publications and resources in support of market transparency and development » ICMA (icmagroup.org)
21 https://www.sifma.org/wp-content/uploads/2020/12/Climate-Finance-Markets-and-the-Real-Economy.pdf
22 Carney, Mark. "The Unbearable Lightness of Beings." Speech at COP15 Finance and Biodiversity Day (December 13, 2022).

rbccm.com

This communication is for informational purposes only. It is not intended as an offer or solicitation for the purchase or sale of any financial instrument, investment product or service. The information contained herein, has been compiled from sources believed to be reliable, but no representation or warranty, express or implied, is made by RBC Capital Markets or any of its businesses or representatives, as to its accuracy, completeness or correctness. To the full extent permitted by law, neither RBC Capital Markets nor any of its businesses or representatives, accepts any liability whatsoever arising from the use of this communication. RBC Capital Markets is a registered trademark of Royal Bank of Canada. RBC Capital Markets is the global brand name for the capital markets business of Royal Bank of Canada and its affiliates, including RBC Capital Markets, LLC (member FINRA, NYSE, and SIPC); RBC Dominion Securities, Inc. (member IIROC and CIPF), RBC Europe Limited (authorized and regulated by Financial Services Authority) and RBC Capital Markets (Hong Kong) Limited (regulated by SFC).
® Registered trademark of Royal Bank of Canada. Used under license. © Copyright 2023. All rights reserved.