Capital Markets

Sustainable Finance Group

Sustainability Matters

Environmental, Social and Governance (ESG) Themes for 2021

JANUARY 2021

INTRODUCTION

2020 was a strenuous year as the COVID-19 pandemic disrupted economies and communities, and the negative consequences will continue to be felt well into 2021. However, 2020 was also the year that demonstrated ESG is a central force that will continue to shape markets. Driven by record flows in sustainable funds and sustainable debt issuance over the past 12 months, 2021 will be the year we see the shift from investor-driven growth in ESG to companies responding to the opportunity. This edition of Sustainability Matters provides an overview of three key themes for the year ahead for RBC Capital Markets' Sustainable Finance Group.

Key Themes for 2021

1. **Companies Propelled into Action**: Global policy alignment and the expectation that the private sector play a role in addressing climate change and inequality will see a shift from investors driving the ESG agenda to the private sector leading the charge.

2. **The Rise of ESG Targets**: Ambitious, time-bound ESG targets will become the norm in 2021, helping fuel the demand and growth in sustainable finance products such as Sustainability-Linked Loans and Bonds.

3. **Sustainability Reporting Gets Rigorous**: Collaboration among sustainability standard setters will create standardization and rigor in ESG reporting, resulting in the continued growth and adoption of climate-risk reporting.

Companies are Propelled into Action Driven by Global Alignment on Climate and Inequality

In 2020, the sustainable investing boom continued, putting to rest any fears that arose early in the year that the global COVID-19 pandemic would derail ESG momentum. In fact, the COVID-19 disruption accelerated sustainable investing[1], driven by investor actions and demand. Globally, AUM in dedicated sustainable investments grew 70% in 2020 to US$711B, with net inflows and new launches hitting new records.[2] ESG ETF AUM doubled in 2020[3] as did the number of dedicated ESG ETFs in Canada. Last year, social bond issuance surpassed US$147B, up 718% YTD compared to 2019.[4] In total, sustainable debt issuance topped US$732B in 2020[5], a new record. We expect the year ahead to continue to see robust inflows to ESG funds but also be defined by corporate action in response to the opportunities presented by global alignment on the green transition and an elevated expectation from stakeholders that companies take a leadership role in addressing issues such as inequality.

Global Policy Alignment on the Green Transition and the Race to COP 26

In 2020, governments laid the foundation for ambitious, science-based commitments to achieve the goals of the Paris Agreement and to-date, 9 of the 15 largest economies have set net-zero targets.[6] In 2021, we expect this momentum to continue, with commitments from additional nations and the release of detailed implementation strategies from countries with existing plans.

In the US, the Biden Administration entered the White House with an ambitious climate change agenda, anchored by rejoining the Paris Agreement, setting a net-zero by 2050 goal for the United States, and committing $2 Trillion over four years to promote investment and solutions to combat climate change.[7] As a signal for what's to come on the climate file under Biden, in December, the Federal Reserve Board announced that it had formally joined the Network of Central Banks and Supervisors for Greening the Financial System (NGFS). The NGFS, which brings together central banks and supervisory authorities, pursues the development of climate risk management for the financial sector.[8] Further signaling the importance of climate for the Biden Administration is the emphasis of climate and sustainable finance expertise among key hires. Namely, a new Cabinet-level post, Special Envoy on Climate was created to which Secretary of State John Kerry was nominated and Biden selected Janet Yellen as his Treasury secretary. Yellen, who has long advocated for the need to build a more inclusive economy and worked to hire more people of color during her tenure as Fed Chair, is also a founding member of the Climate Leadership Council, a key proponent of carbon tax and carbon dividend mechanisms.

In Canada, we expect Bill C-12, the Canadian Net-Zero Emissions Accountability Act, introduced in the House of Commons in November, to become law. The enactment of the bill would require national targets for the reduction of GHG emissions in Canada to be set, with the goal of attaining net-zero emissions by 2050. Interim targets for 2030, 2035, 2040 and 2045 would be set by the Minister of Environment. While the Bill does not include an enforcement mechanism, it is expected to accelerate the adoption of emission reduction plans and strategies in the private sector, an area where Canadian companies have already demonstrated leadership, with many corporate leaders putting 2050 net-zero goals in place. Canadian regulators took action with the Bank of Canada and the Office of the Superintendent of Financial Institutions (OFSI) announcing a pilot in November, involving banking and insurance sector participants including RBC, to better understand the risks to the economy related to the transition to a low-carbon economy.[9]

In the United Kingdom, Boris Johnson announced his government's 10-point green plan, which he cited as a catalyst that would generate 250,000 new jobs.[10] The plan calls for a sales ban of internal combustion engine (ICE) vehicles in the UK by 2030, quadrupling offshore wind power by 2030, enough to power every home in the UK, investments towards hydrogen, nuclear power, and carbon capture, along with making London the global center of green finance. While praised as a step in the right direction, Johnson's plan is expected to only close 55% of the gap in the UK's climate goals, thus falling short of the UK's net-zero ambitions.[11] The government indicated the policy document was only the start and we expect further details on how the UK plans to meet its climate commitments in 2021, ahead of COP 26, the United Nations Change Conference which will be held in Glasgow in November.

The concrete, meaningful strategies and legislation in the US, Canada and the UK add to efforts globally, including net-zero plans introduced in France, New Zealand, Sweden, Australia, Denmark, Hungary, Japan and China, highlighting the salience of climate change as one of the main issues of focus for governments in 2021 in the lead up to COP 26, where we expect to see further convergence of climate policy and enhanced commitments from nations. COP 26 will also feature the Private Finance Agenda, which aims for every professional financial decision to take climate change into account.[12] We expect the Private Finance Agenda to result in alignment and announcements on the financial sector's role in financing the transition to a net zero future.

Distrust in Institutions Increases the Role of the Corporate Sector in Addressing Inequality

In 2020, the Edelman Trust Barometer showed that a growing sense of unfairness in the system was driving distrust across institutions.[13] Over the course of the year, corporates responded to the racial inequality and injustice prevalent in society, and to the fact that those with less education, less money and fewer resources were bearing a disproportionate burden of the health and economic impacts caused by COVID-19.[14] The year ahead is a moment of truth for business, where companies can recognize that they play a pivotal role in creating a more just and inclusive future for all people, especially at a time where stakeholders' trust of other institutions has been challenged.

So far, the corporate sector has met the moment and responded to the challenge. Research from RBC Capital Market's US Equity Strategist Sara Mahaffy highlighted that 40% of S&P 500 companies discussed diversity and inclusion on quarterly earnings calls in Q2 2020, a marked increase from previous years.[15] In 2021, we expect a spotlight to continue to remain on diversity and inclusion efforts, as doing so offers an economic incentive. According to Mahaffy, "since 2014, companies with higher workforce ESG scores have outperformed those with lower workforce ESG scores within both the S&P 500 index and S&P Europe 350 index".[16] It was not only corporates pushing diversity efforts forward. In December, NASDAQ submitted a proposal to the Securities and Exchange Commission (SEC) to adopt new listing rules related to diversity and inclusion. The rules would call for companies to be removed from the exchange should they fail to have at least two diverse directors, including one who self-identifies as female and one who self-identifies as either an under-represented minority or LGBTQ+.[17] Analysis by NASDAQ indicated that currently, nearly 75% of its nearly 3,000 listed companies would not meet its proposed criteria[18], highlighting the work that needs to be done.

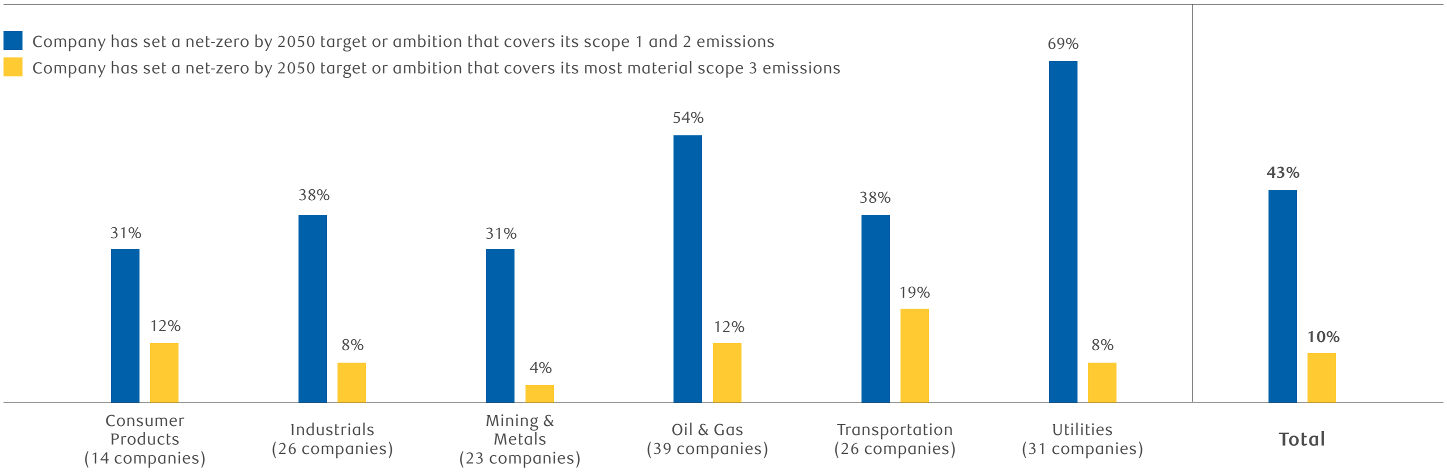
Investors are also increasingly asking issuers to provide additional workforce and human capital data via shareholder proposals[19] as the COVID-19 pandemic has elevated interest in topics such as protecting the health and safety of employees and customers, remote working challenges, succession planning and the impact of these matters on business continuity.[20] Investors are also looking to delve into areas of explicit and implicit discrimination in the workplace, and we expect a large focus of the proxy season will be on matters of diversity, inclusion and inequality within the workforce.

Rise of ESG Targets

Across all industries and geographies, we expect continued effort from companies to commit, set and disclose ESG targets. Targets will span all ESG areas, including environmental, social and governance factors. In particular, we expect an emphasis on targets in the area of net-zero emissions and diversity and inclusion, largely driven by investor engagement and demand. Companies who fail to meet this expectation can expect investor push back, and the potential risk of losing or not accessing ESG-oriented pools of capital.

In 2020, 43% of the 160 companies that represent over 80% of all industrial GHG emissions globally, set a net-zero target or ambition.[21] We expect to see increasing growth in the number of companies articulating their net-zero ambitions in 2021, with time-bound, science-aligned targets becoming the norm. On diversity and inclusion, last year, 38% of S&P 500 companies announced new initiatives and action plans to address racial inequality. In the year ahead, we expect these commitments to translate to quantitative targets to increase representation in the workforce and address issues of inequality.

CORPORATE NET-ZERO TARGETS BY INDUSTRY AND SCOPE



Source: Climate Action 100+

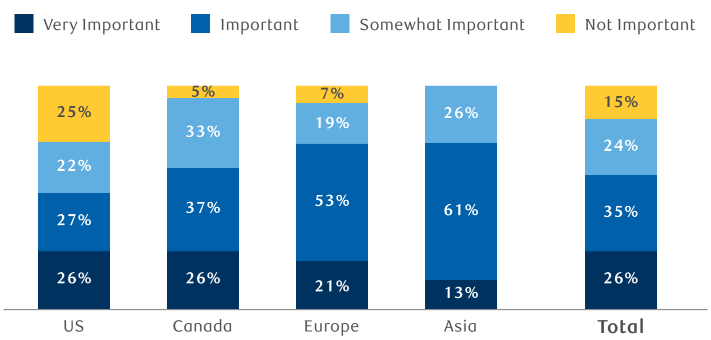
Whereas to-date companies have received positive benefit from merely announcing their support of a net-zero ambition and/or the support of diversity and inclusion efforts, 2021 will be characterized by increasing scrutiny on the efficacy of such plans and targets. Sustainability reporting that includes a backwards look at a company's performance will no longer be enough – companies will be expected to articulate their vision for a sustainable future and how they plan to get there.

The enhanced scrutiny of ESG targets and performance will be driven by investors. Climate Action 100+, an investor-led initiative consisting of 545 signatories with US$52 Trillion AUM, will roll-out its Net-Zero Company Benchmark in early 2021. The Benchmark was developed through collaboration with over 50 investor signatories, investor network experts, leading climate research and data NGOs, and corporate stakeholders, and will provide transparency and clarity, through publically available scorecards, on specific indicators designed to assess the quality of a company's net-zero strategy, and compare it with peers.[22]

Investors will also call for additional diversity and inclusion disclosures in 2021, fueling the growth in ESG targets. Blackrock, the world's largest asset manager, stated in December that it will ask companies for greater racial and gender diversity on boards and in workforces in 2021.[23] State Street Global Advisors also announced that it would ask for companies for metrics and plans related to boosting racial diversity.[24]

Research from RBC Global Asset Management indicated that 44% of investors globally favored board minority diversity targets, while 49% favored gender diversity targets. In addition, 85% of investors globally indicated that the disclosure of diversity & inclusion policies was an important factor to consider for companies in which they were planning to invest.[25]

HOW IMPORTANT IS DIVERSITY AND INCLUSION DISCLOSURE FOR COMPANIES IN WHICH YOU ARE PLANNING TO INVEST?

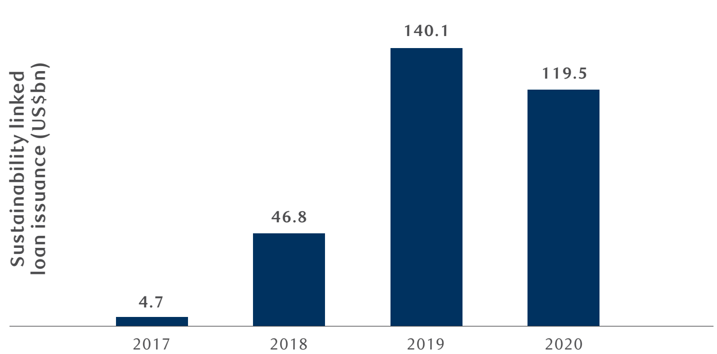


Source: RBC Global Asset Management

The Rise of ESG Targets will Fuel Demand for Sustainable Finance Products

In 2021, we expect the issuance of sustainability-linked debt, including loans and bonds to surge, with the rise in corporate ESG targets providing companies with the opportunity to use the structure to signal their commitment to sustainability to investors and stakeholders. Sustainability-Linked Loans (SLLs) are loans with predetermined sustainability targets and the potential for pricing adjustments based on performance against those targets. They provide borrowers with an incentive to improve their sustainability profile. In 2020, total SLL issuance surpassed US$119B and SLLs are one of the fastest-growing subsets of the sustainable debt market, reaching U$311B in volume since inception in 2017. SLLs are appealing to borrowers as they can be tailored to a company's specific sustainability strategy and goals. While SLLs typically include an environmental target(s) related to emissions reduction or renewable energy procurement, increasingly, we are seeing borrowers include targets across social and governance factors as well. Social and governance targets can relate to areas such as workforce diversity and inclusion targets, supplier diversity, or health & safety, to name a few. In 2020, RBC Capital markets participated in 13 Sustainability-Linked Loans representing a total commitment of C$2,894 million for clients in a variety of sectors across Europe and North America.

TOTAL SUSTAINABILITY-LINKED LOAN ISSUANCE (US$BN)



Source: BNEF

Collaboration Brings Rigor and Standardization to Sustainability Reporting

The lack of standardized, comparable ESG data across industries and geographies has been commonly cited by regulators, central banks, investors, stock exchanges and corporate reporters as a constraint to the growth and mainstreaming of ESG. In 2020, we began to see efforts from a variety of stakeholders, from investors to regulators to standard setters, to coalesce around specific standards and frameworks as the recommended disclosure guidance for reporters. In addition, we saw efforts to consolidate disparate reporting efforts by several players in order to promote commonality and comparability. In 2020, adoption of the SASB standards also gained momentum within the corporate community as 500 companies disclosed SASB metrics in the past year, a 325% increase from 2019.[26] In the year ahead, the standardization of sustainability reporting will have key implications for investors and companies. For investors, it will help ensure comparable data is available, allowing for more accurate evaluation of the ESG performance and transition strategies of corporates. For companies, it will ensure ESG metrics and KPIs exist that are aligned to widely accepted standards and guidance, providing a foundation from which to easily participate in sustainability-linked debt issuance, if appropriate.

Standardization of sustainability reporting in the year ahead is a result of collaborative efforts in 2020 where the major players in sustainability disclosure, the Carbon Disclosure Project (CDP), Climate Disclosure Standards Board (CDSB), Global Reporting Initiative (GRI), International Integrated Reporting Council (IIRC) and Sustainability Accounting Standards Board (SASB), declared their intent to collaborate and released a shared vision for a comprehensive sustainability reporting system.[27] The commitment to collaborate and promote simplicity in sustainability reporting was further cemented in November when SASB and IIRC announced a formal merger.[28] Earlier in September, the International Financial Reporting Standards (IFRS) Foundation released its Consultation Paper on Sustainability Reporting, requesting feedback and input on the need to create an internationally recognized, globally applicable sustainability standard. The IFRS Foundation proposals calls for the creation of a new Sustainability Standards Board (SSB), with governance structures similar to the well-established International Accounting Standards Board (IASB). The proposed SSB is not designed to compete with existing initiatives, rather, it will promote collaboration among the established bodies and leverage the expertise of the IFRS Foundation in developing global standards to promote harmonization and consolidation of metrics, frameworks and disclosure requirements.[29]

Adoption and support of the recommendations of the Task Force on Climate-related Financial Disclosure (TCFD) is also increasing. TCFD reporting, which helps companies report on their physical and transition related climate risks, became mandatory for UN PRI signatories in 2020 and will become required in certain jurisdictions, including the UK and New Zealand.[30] We expect further announcements of required TCFD reporting from countries in 2021.

Closing Thoughts

2020 was the year when sustainable finance and ESG was defined by investor action and acceleration of sustainable fund flows, passing the early test caused by the disruption of COVID-19. In the year ahead, global policy alignment in the lead-up to COP 26 and the expectation that companies play a pivotal role in addressing challenges such as climate change and inequality, will see the corporate sector respond with commitments in both areas. Investor expectations will also ensure that such commitments move from ambitions into tangible targets that are time-bound and in the area of climate, aligned to a science-based pathway to meet the goals of the Paris Agreement. The rise of ESG targets for corporates and the enhanced rigor we expect to see in sustainability reporting in 2021 due to collaborative efforts underway from standard-setters will be a catalyst for increased sustainability-linked debt issuance in 2021, across all sectors and geographies. All in all, 2021 will be the year of corporate action, where we see companies 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**

Lindsay Patrick
Managing Director and Head,
Strategic Initiatives & ESG
lindsay.patrick@rbccm.com

Sarah Thompson
Director
Sustainable Finance
sarah.e.thompson@rbccm.com

Navi Brar
Vice President
Sustainable Finance
navi.brar@rbccm.com

Gabriela Furtado
Vice President
Sustainable Finance
gabriela.furtado@rbccm.com

Nicola Milne
Vice President
Sustainable Finance
nicola.milne@rbccm.com

Lauren Iantomasi
Associate
Sustainable Finance
lauren.iantomasi@rbccm.com

Natalie Marcuzzi
Analyst
Sustainable Finance
natalie.marcuzzi@rbccm.com

1. https://www.ft.com/content/5145f43c-009c-4309-a23a-bbb4828f6d4f?desktop=true&segmentId=7c8f09b9-9b61-4fbb-9430-9208a9e233c8#myft:notification:daily-email:content
2. RBC Capital Markets, The ESG Scoop, January, 2021
3. https://www.ft.com/content/5145f43c-009c-4309-a23a-bbb4828f6d4f?desktop=true&segmentId=7c8f09b9-9b61-4fbb-9430-9208a9e233c8#myft:notification:daily-email:content
4. BNEF
5. BNEF
6. Climate Action 100+ 2020 Progress Report
7. https://www.nytimes.com/2020/07/14/us/politics/biden-climate-plan.html
8. https://www.federalreserve.gov/newsevents/pressreleases/bcreg20201215a.htm
9. https://www.bankofcanada.ca/2020/11/bank-canada-osfi-launch-pilot-project-climate-risk-scenarios/
10. https://www.theguardian.com/environment/2020/nov/17/boris-johnson-announces-10-point-green-plan-with-250000-jobs
11. https://www.carbonbrief.org/media-reaction-boris-johnsons-10-point-net-zero-plan-for-climate-change
12. https://www.bankofengland.co.uk/events/2020/february/cop26-private-finance-agenda-launch
13. https://www.edelman.com/research/trust-2020-spring-update
14. https://www.edelman.com/research/trust-2020-spring-update
15. RBC Capital Markets, The ESG Scoop, August, 2020
16. RBC Capital Markets, The ESG Scoop, August, 2020
17. https://www.irmagazine.com/esg/nasdaq-targets-board-diversity-comply-or-explain-plan
18. https://www.wsj.com/articles/companies-face-new-pressures-to-diversify-boards-its-sensitive-11607380004
19. https://www.nortonrosefulbright.com/en/knowledge/publications/3112fda4/proxy-season-2021-navigating-turbulent-times
20. https://corpgov.law.harvard.edu/2020/10/15/2021-proxy-and-annual-report-season/
21. Climate Action 100+ 2020 Progress Report
22. Climate Action 100+ 2020 Progress Report
23. https://www.bnnbloomberg.ca/blackrock-plans-to-push-companies-on-racial-diversity-in-2021-1.1534367
24. https://www.bnnbloomberg.ca/blackrock-plans-to-push-companies-on-racial-diversity-in-2021-1.1534367
25. RBC Global Asset Management 2020 Responsible Investment Survey
26. SASB
27. SASB
28. https://www.sasb.org/wp-content/uploads/2020/11/IIRC-SASB-Press-Release-Web-Final.pdf
29. https://www.ifrs.org/news-and-events/2020/10/hope-for-a-new-paradigm-sustainability-reporting/
30. MSCI 2021 ESG Trends

rbccm.com