
ESG Outlook 2022

Impact assessment takes centre stage as financial regulators and standard-setters grapple with measuring sustainability. Can carbon pricing address climate reporting's complexity and the risk of greenwashing?

ESG, Scope SE & Co. KGaA, 9 February 2022



Executive summary

With net zero well beyond reach of current policies and technologies, investors are increasingly scrutinising the impact of their ESG strategies on the real economy and their contribution to decarbonisation or diversity.

Improved disclosure by companies is vital to help market participants assess ESG impact.

However, expanded accounting and regulatory frameworks to simultaneously serve multiple stakeholders risks turning out to be lengthy, costly, and insufficiently orchestrated.

A complementary – if not more effective - approach is to ensure that negative externalities are directly reflected in financial statements through, in the case of greenhouse gas emissions, better and more transparent carbon pricing.

We see two main trends shaping the debate surrounding corporate sustainability during 2022:

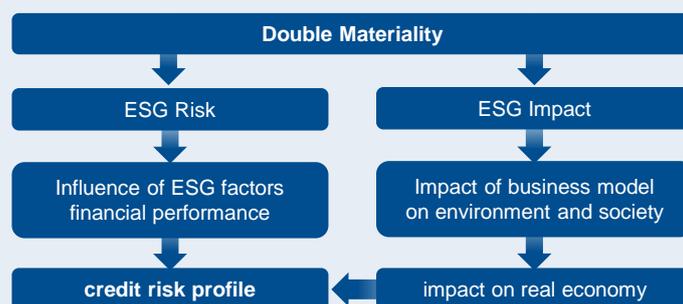
- The regulatory and policy-making focus will remain on tackling climate-related issues.
- ESG research will increasingly re-emphasise impact assessment over ESG-linked risks.

This is important from a credit perspective.

Fixed-income investors typically neither take part in the financial upside involved with large-scale climate investments nor are they in a position to bear the associated project and technology risks. However, bondholders require assurance that their funds refinance assets in line with ESG values.

In any case, ESG impact and ESG risk analysis are converging over the long term because one actor's ESG impact drives another actor's ESG risk and vice versa. This applies especially for the systemic risks posed by global warming. Large corporates and regulators increasingly focus on indirect reporting of emissions accruing in the value chain ("Scope 3"). Accounting for supplier footprints and emissions in final consumption aligns directly exposed industries ("risk") with their neighbouring sectors ("impact").

This "double materiality" of ESG risk and ESG impact will shape the debate over disclosure and accounting materiality but also influence discussion of how best to assess the ESG profile of an investment and its classification, for example, under a taxonomy such as the EU's.



However, there are alternatives to cumbersome reporting frameworks that allow investors to assess impact, for example by improving the pricing of carbon emissions.

Direct pricing of many ESG impacts could yet prove the most effective way to evaluate the sustainability of complex companies and their value chains.

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ESG Outlook 2022: can carbon pricing address climate reporting's complexity, greenwashing risk?

With net zero well beyond reach of current policies and technologies, investors are increasingly scrutinising the impact of their ESG strategies on the real economy and their contribution to decarbonisation or diversity. Improved disclosure by companies is vital to help market participants assess ESG impact. However, expanded accounting and regulatory frameworks to simultaneously serve multiple stakeholders will be lengthy, costly and insufficiently orchestrated. A complementary – if not more effective - approach is to ensure that negative externalities are directly reflected in financial statements through, in the case of greenhouse gas emissions, better and more transparent carbon pricing.

Double materiality increasingly the focus of sustainability debate

We see two main trends shaping the debate surrounding corporate sustainability during 2022. First, the focus will remain on climate change. Secondly, ESG research will increasingly re-emphasise impact assessment over ESG-linked risks.

This is important from a credit perspective. Fixed-income investors typically neither take part in the financial upside involved with large-scale climate investments nor are they in a position to bear the associated project and technology risks. However, bondholders require assurance that their funds refinance assets in line with ESG values.

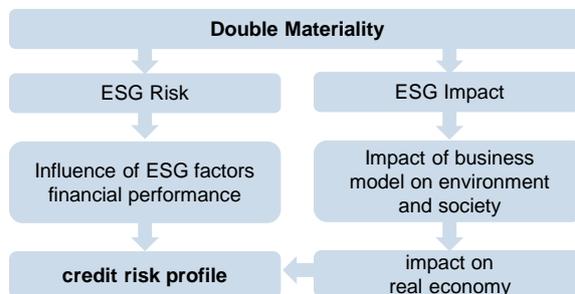
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However, there are alternatives to cumbersome reporting frameworks that allow investors to assess impact, for example by improving the pricing of carbon emissions. Direct pricing of many ESG impacts could yet prove the most effective way to evaluate the

sustainability of complex companies and their value chains.

Figure 1: Feedback loop – impact and risk in ESG assessment

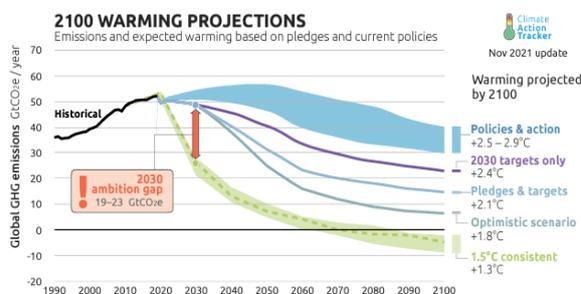


Climate action failure drives ESG agenda

Post COP26, investors remain focused on a scenario where countries and companies fail to meet their 2050 net zero climate targets. This "ambition gap" partly reflects lack of international consensus, notably in terms of the reluctance of the US and China to make strong commitments.

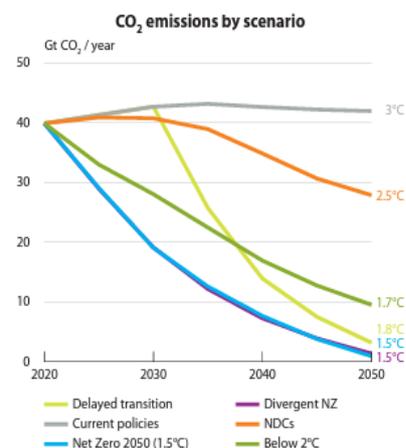
The gap also reflects doubts about the cost and feasibility of the carbon-neutral strategies proposed, such as switching to renewables while also increasing energy production as the global economy grows and living standards improve.

Figure 2. Global warming scenarios



Climate Action Tracker Nov 2021, NGFS Climate scenarios June 2021

Figure 3. Global emissions scenarios



Climate Action Tracker Nov 2021, NGFS Climate scenarios June 2021

Under a delayed policy scenario (“disorderly transition”) – such as the one envisaged by leading central banks in the Network for Greening the Financial System (NGFS) - investors and issuers can expect significantly tighter restrictions on carbon emissions from 2030, leading to possible supply-side shocks and stagflation or “greenflation”.

This has led to yet more rhetoric and climate commitments by investors and banks to achieve net zero, notably by the recently formed Glasgow Financial Alliance for Net Zero. However, the vital issue is the impact that today’s ESG-led investment decisions have on the real economy, measuring progress toward zero-carbon goals and holding companies to account.

Greenwashing risks undermining ESG frameworks

As the stakes rise for ESG investing, greenwashing has emerged as a major concern for investors. Companies and entire countries increasingly stress their environmental and social credentials to access financing with ESG-labelled bonds and loans, a segment of the market which has grown rapidly and is likely to continue to do so. In Europe, ESG-linked debt from non-financial companies will account for a third of the bonds issued in 2022, up from around a quarter last year, and only 8% in 2020. Despite their rising supply, ESG linked bonds demand a premium due to strong demand, even though it is often not clear what, if anything, these investments contribute to ESG goals. While, for example, proceeds from green bonds are under scrutiny to simply refinance existing assets, [sustainability-linked bonds often lack ambition](#) in defined objectives and/or [small additional premia](#) for missing pre-defined targets.

Investors are therefore facing questions whether and how their ESG-led investment strategies contribute towards a “green” or “stakeholder” economy. These concerns are amplified by regulatory and litigation risks related to the labelling of funds, for example, under the EU’s Sustainable Finance Disclosure Regulation (SFDR) that requires asset managers to make impact disclosures from 2023.

Thus, significant efforts are required urgently to bridge the gap between ambition and reality in ESG investing.

ESG disclosure: the push towards mandatory reporting

It is widely accepted that ESG assessments require better disclosure of non-financial information related to environmental and social factors. While this point is hardly controversial, better pricing of external effects such as carbon emissions may offer an alternative way of directly measuring impact in the financial accounts of a firm.

Strikingly, the widely acknowledged disclosure gap is neither due to lack of effort nor rhetoric. Numerous disclosure frameworks at global, regional, and national

levels have been available for many years, and most listed companies maintain that they adhere to at least one of them.

Our non-exhaustive list identifies at least 10 frequently cited standards that cover various aspects of ESG-related financial and non-financial information. Yet, confusion reigns because disclosures are mainly qualitative and at times trivial, while quantitative disclosure remains voluntary and difficult to compare.

Organisation	Standard	latest
ISSB	International Sustainability Standards Board	Global standard for sustainability-related disclosure 2021
CDSB	Climate Disclosures Standards Board	Framework for reporting environmental information 2019
SASB	Sustainable Accounting Standards Board	Standards for financially material ESG information 2011
IIRC	International Integrated Reporting Council	Framework for integrated reporting 2021
EU	Non-financial Reporting Guidelines	non-binding reporting standard for large EU corporates 2019
WEF	Measuring Stakeholder Capitalism Initiative	ESG indicators for UN SDGs 2019
TCFD	Task Force on Climate-related Financial Disclosures	Framework for climate-related financial disclosures 2017
GRI	Global reporting initiative	Standards for impact reporting 2016
GHG	Greenhouse Gas Protocol	Standards for measuring greenhouse gas emissions 2015
CDP	Carbon Disclosure Project	Global disclosure platform for environmental impact 2000

The big question for 2022 is therefore how quickly standard setters can agree on binding standards for non-financial disclosures, if at all. Progress in this area is vital, not at least because other flagship projects such as the implementation of the EU’s SFDR and taxonomy depend on it.

Corporate Sustainability Reporting to become mandatory in the EU from 2023

The EU plans to amend several accounting-related directives for its 27 member states, which will require companies to report to a binding sustainability standard (CSRD) from 2023, initially for environmental information and large corporates. The EU also plans to expand a subset of the core principles to much smaller companies and make integration into regular financial reporting mandatory. However, the details of the reporting standard have yet to be agreed upon and aligned with other initiatives in this field.

IFRS foundation forms dedicated Sustainability Standards Board

Concurrently, IFRS Foundation created a new International Sustainability Standard Board (ISSB) to agree on binding disclosure standards modelled on existing frameworks such as the SASB or the CDSB. Again, the focus is initially mainly on environmental risks. While the ISSB will work in close co-operation

with the IASB to ensure consistency, it is not clear, yet, whether future ISSB standards will be applied the same way as IFRS standards.

A main strength of this initiative is that the ISSB's reach is considerably wider than the EU's because IFRS accounting is used in more than 120 countries, including the EU, though excluding the US which is among the largest emitters of greenhouse gases.

Pitfalls of non-financial disclosure

Reaching agreement on non-financial disclosure standards is anything but trivial because double materiality requires companies not only to report how they are affected by ESG risks but also on how their business affects other stakeholders and the environment. But which stakeholders should be considered? The wider the definition, the higher the burden and the lower the objectivity of the required technical standards.

For its part, the EU has been using a very wide definition of stakeholders but has not been able to translate their requirements into binding standards. Likewise, the ISSB has already identified seven cross-sector metrics for climate risk, which are to be complemented by specific environmental standards for 77 subsectors.

This does not yet include reporting on social factors of diversity, equality, and inclusion. The danger is that the complexity of these frameworks can quickly spin out of control, making it hard to reach consensus in view of their cost, especially for small companies.

Defining the scope of non-financial reporting risks catch-22 situations

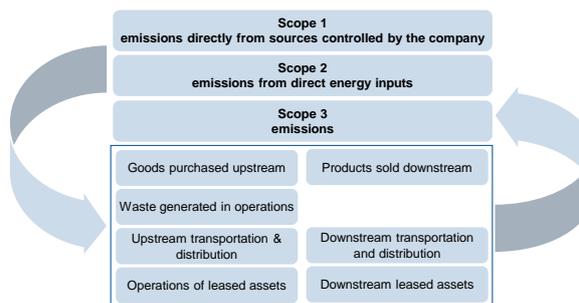
In line with an expanded definition of materiality, any binding standard for non-financial disclosure needs to set the much wider boundaries for the measurement of the environmental and social impact of a business, especially its impact through supply chains and through the end-use of its products.

The measurement of upstream and downstream impact addresses long-standing concerns that companies, sectors, or indeed entire countries may be underestimating their climate risk impact when promoting net-zero targets. Both the ISSB and the EU standards will therefore require companies to report material so-called "scope 3" emissions of greenhouse gases in their value chain both upstream and downstream – a potential catch-22 situation for many sectors for as long as global reporting standards remain fragmented or non-existent.

A good example is the financial sector, which is expected to report on its own scope-3 emissions caused by downstream lending, which is only possible once borrowers provide reliable data to lenders.

Emphasis on scope 3 is no doubt welcome but the materiality and the benefits of the disclosure will differ considerably from industry to industry. Sectors producing fossil fuels and those producing fossil fuel consuming assets represent the bulk of global scope-3 emissions, yet the relative share of scope-3 emissions is high in industries where absolute emissions are considerably lower.

Figure 4: The “catch 22” of ESG disclosure: reporting on scope-3 emissions



The main advantage of wider emission reporting is the increasing shared responsibility between emission-intensive industries and those industries, whose business models indirectly rely on emission-intensive inputs and/or final consumer goods.

The shared responsibility through multiple-counting – scope 1 emissions of direct polluters show up again in scope 3 emissions of upstream and downstream industries – raises incentives across industries to reduce emissions where they occur in the first place instead of allocating the full burden to single sectors such as the cement industry.

The benefits of a wider boundary for reporting in low-emitting industries need to be weighed against the cost and risk of inconsistent disclosures for complex value chains and products. The Greenhouse Gas Protocol defines different calculation methodologies for scope-3 reporting, depending on the information available from suppliers and the use of final product. This puts companies in a difficult position when more granular information raises the scale of reported emissions relative to competitors who report only on non-material sub-categories of scope 3 such as business travel rather than, for example, impacts from final use.

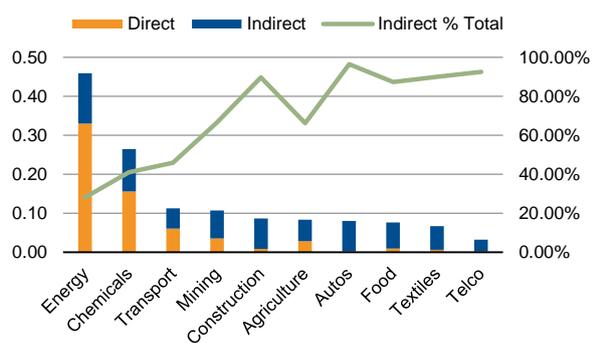
The complexity of disclosing indirect emissions pushes regulators, standard setters and agencies towards harmonising accounting standards such that corporates, financial market participants and final consumers can better distinguish between the desired scale of reporting and final disclosed outcomes.

Orchestrating this important need will be a key priority for the ISSB's accounting standards. Once a harmonised reporting framework is globally accepted, different climate ambition levels across countries are less likely to result in competitive disadvantages for companies residing in jurisdictions with stricter emission standards. The main challenge for standard

setters is to set guidelines for reporting scope-3 emissions across jurisdictions, especially those lacking reliable data.

Figure 5: Direct and indirect impact of greenhouse gases by economic activity

Cost of emissions impact for every euro of revenue (EUR, lhs); proportion attributable to indirect emissions (% , rhs)



Source: Scope ESG

EU Green Deal requires robust non-financial reporting

The EU has decided to push ahead with a binding framework for sustainable investments as part of its Green Deal package despite the challenges posed by fragmented or non-existent non-financial reporting. Seen as a breakthrough for ESG impact assessment, the framework will initially cover only climate and has yet to be expanded to other environmental and social activities. The European Commission also plans to expand carbon pricing and impose a carbon-border tax to avoid carbon leakage outside of the EU. None of these initiatives can be implemented and evaluated without a robust accounting framework for environmental and social impact.

From 2022, large financial and non-financial corporates are required to disclose the share of their business and investments that are aligned with the yet-to-be-released detailed climate taxonomy. Almost by design, the initial alignment of companies' activities with the proposed taxonomy is likely to be low because carbon emitting activities still dominate large parts of the economy and reporting is not available in the face of complex and detailed technical screening criteria and do-no-significant-harm conditions, which exacerbate translation into accounting frameworks. Thus, few companies will initially benefit from the taxonomy, and many will struggle with the reporting in the first place.

The potential for funding disruption from a rigid and intrusive taxonomy is therefore high, especially where the underlying data is not yet available or questionable. The well-publicised controversy over the exclusion of coal from the taxonomy and the classification of gas and nuclear as transition technologies for the energy sector is only one example. The introduction of new technologies will lead to further controversies over time

as will the classification of improvements to existing technologies.

Given the challenges posed by accurate ESG reporting, these controversies are likely to be only the tip of the iceberg as companies will struggle to prove that their climate mitigation and climate adaption activities qualify for the taxonomy, especially where they are not related to revenues but to bundled services or other improvements to their carbon footprint from lower scope 3 emissions.

Environmental activists and NGOs as well as transition industries criticise the taxonomy for its dual distinction between sustainable and non-sustainable activities in drawing a line where activities cannot be easily classified. At the same time, the framework stipulates complex provisions for certain sectoral activities, which put high regulatory burden on environmentally ambitious companies seeking to show a high share of taxonomy alignment. As such, the taxonomy may end up as a classification system widely disregarded by market participants through zero disclosures. In a more likely scenario, some industries will compete on taxonomy-alignment (such as the energy sector) while zero-disclosures dominate in activities with very high reduction targets (such as cement or gas) or very specific and/or complex provisions (such as in manufacturing).

Is carbon pricing the better alternative?

Economists have long argued that a Pigouvian tax – a levy on negative externalities such as carbon-dioxide emissions - is the most cost-efficient way to steer economies away from unfavourable market outcomes. For the climate transition, taxation and pricing of emissions largely eliminates the complexities of emissions reporting by directly allocating their external cost to a product and making it straightforward for companies to quantify their impact.

Broadly speaking, economists favour a Pigouvian tax on emissions in consumption while using emission trading systems to control and to ultimately reduce absolute levels of emission within a jurisdiction.

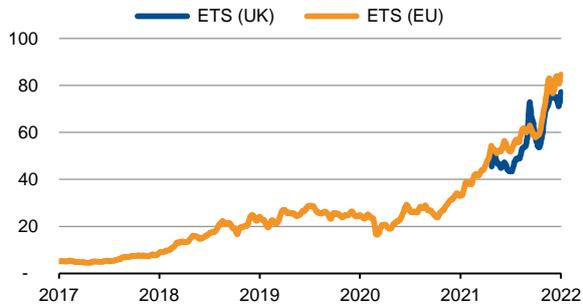
Carbon taxes such as fuel duties or energy taxes already generate significant revenue for governments, but their implementation has been driven mostly by political expediency and are often overridden by the volatility in global energy markets. While consumption taxes are less likely to distort competition, different incentives and wide-ranging subsidy schemes for renewables and energy-efficiency measures continue to create undesirable uncertainties for industries.

Emission systems have the advantage of reducing emissions, where the reduction is least costly. This market mechanism, however, depends on the total allocation of permits and its applicability in a globalised economy, that is highly subject to carbon leakage through wide-ranging and complex supply chains. In

In addition, emissions trading schemes are often perceived as arbitrary due to their dependence on pre-allocated quotas and their limited applicability beyond the utilities sector.

Figure 6: Slow burn

European carbon pricing 2017-2022 (EUR/tonne)

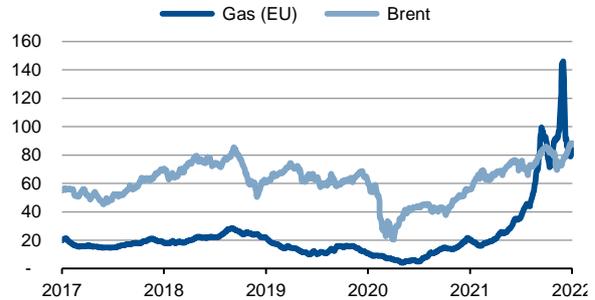


Thus, renewed efforts in this area are vital - and we see signs of some progress.

The formation of a G7 “carbon club” may provide a basis for more international co-ordination, especially for minimum prices.

Figure 7: Pandemic aftershocks, geopolitics roil energy markets

Crude oil, natural gas prices (USD/barrel of oil/oil equivalent)



The planned expansion of the EU’s ETS to transport and buildings will widen the reach of carbon pricing in the EU as will the carbon border adjustment mechanism which proposes a levy based on the carbon-content of selected imports to the EU.

Such projects are necessary complements for ESG investors to assess impact and risk of their investments.

Annex I: Related research

“Europe’s difficult balancing act: managing the energy transition amid a geopolitical crisis”, published Feb 2022 available [here](#)

“Schuldschein set up for strong 2022 on jumbo deals, ESG-linked transactions, refinancing”, published Feb 2022 available [here](#)

“Supranational climate risks: European lenders have best country-risk profiles”, published Jan 2022 available [here](#)

“Unilever’s deal quest puts spotlight on sector’s sustainable-growth challenge”, published Jan 2022, available [here](#)

“Europe’s social-, sustainability-linked corporate bond issuance surges as issuer base widens”, published Jan 2022, available [here](#)

“European sovereign ESG risk: governments in danger of underestimating adverse demographic trends”, published Nov 2021, available [here](#)

“ESG and digital transition as measures of long-term sustainability for banks”, published Jan 2022, available [here](#)”, published Nov 2021, available [here](#)

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