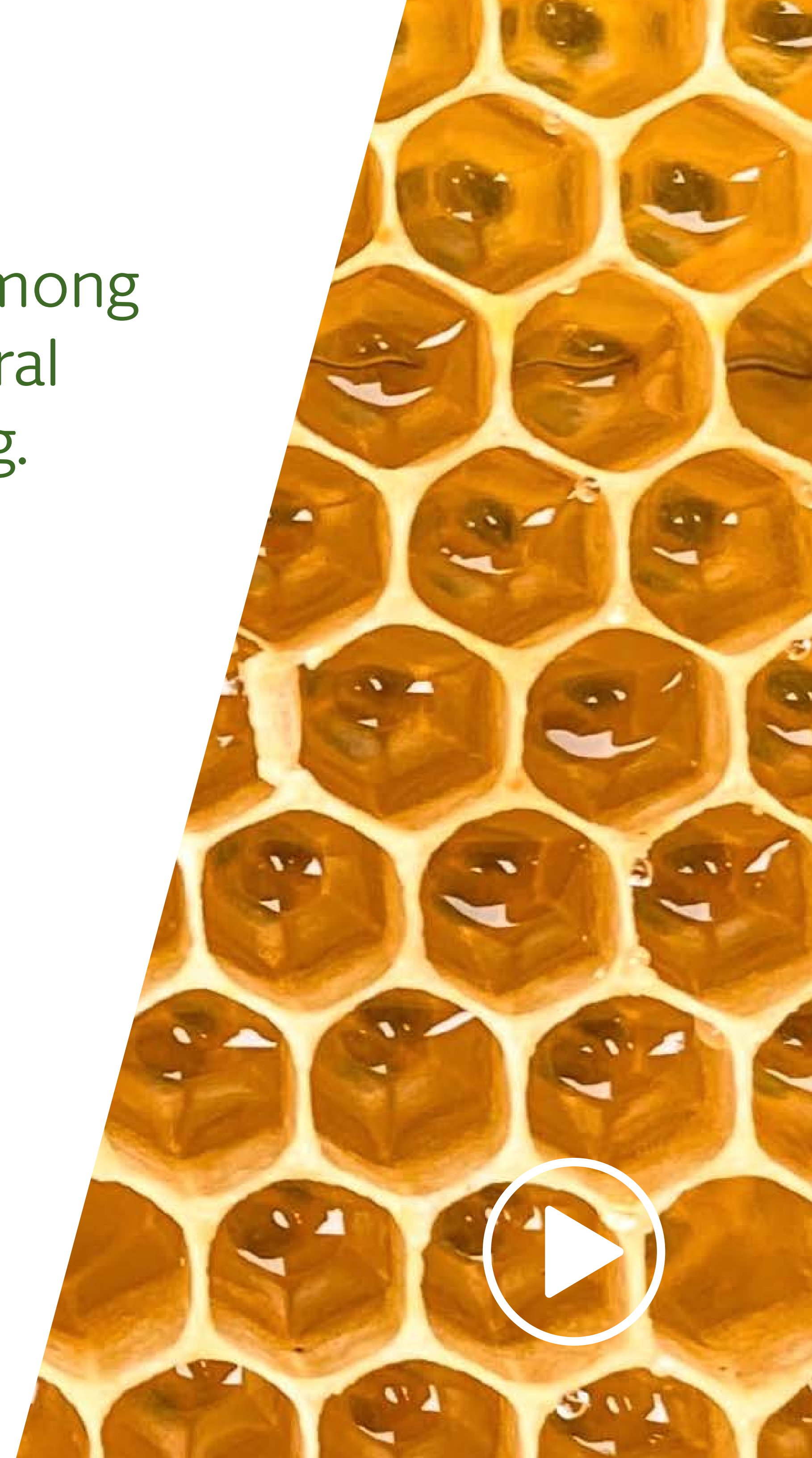
Hogan Lovells

ESG
Environmental, social and governance

ESG trends to watch

As ESG issues are increasingly driven by regulatory change and a growing awareness of their impact among key business stakeholders, they have become central to many businesses' core strategic decision-making. We see ESG ripples across all industries, sectors and geographies, whether from evolving laws and regulations, the rapid growth in impact financing and investing, or the continued dialogue about diversity and inclusion, among just a few factors.

Against this landscape, we've laid out the five key ESG trends that we see having the most impact on businesses in the year to come, and provided some thoughts on how you can prepare to respond.



1. The crystallisation of regulations

While ESG has long been a topic of conversation and consideration, the increasing regulatory mandates for investor-grade, high-quality ESG disclosure is one of the most significant factors driving change. Such disclosures will expose a company's risks and opportunities to the market, at the consumer, investment, and regulatory levels.

While the requirements are growing, numerous obstacles nonetheless stand in the way of fully embedding the reporting side of ESG regulation into business practices. The ESG landscape is constantly changing. There is a growing body of laws and regulations governing the disclosure of environment and climate-related data which increasingly aim to scrutinise green claims and require the true integration of sustainability into investment decision-making.

While recent regulatory developments demonstrate a hardening of ESG disclosure responsibilities, the wide range of regulations, standards, and frameworks are hard to navigate. By way of example:

a) The European Parliament approved a new voluntary gold standard with mandatory requirements for the issuance of green bonds in the EU as well as other optional sustainability-linked disclosure requirements for sustainability-linked bonds in the EU

b) The European Commission amended the Accounting Directive to reduce the scope of the application of the Corporate Sustainability Reporting Directive (CSRD) meaning that less companies will fall within scope of the regime

c) Under the EU Corporate Sustainability Reporting Directive's (in force from 2024) first reports are due to be published in 2025. The Directive modernises and strengthens the rules concerning ESG disclosures for companies and will affect a broader set of large companies and listed SMEs. Companies will report according to the European Sustainability Reporting Standards, which will be tailored to EU policies, whilst building on and contributing to a greater standardisation of ESG disclosure globally

d) In the UK, the Taskforce on Nature-related Financial Disclosures (TNFD) published its final recommendations for managing and disclosing nature-related risks and the UK Transition Plan Taskforce (TPT) released its final disclosure framework setting out standards and guidelines for entities drafting their transition framework

e) In the US, California legislature passed a bill that would force large companies to provide Scope 3 emissions (suppliers and customers) climate reports by 2027.

Effectively consolidating existing reporting practices with the new and emerging frameworks will be key to a company's success, particularly when operating across multiple jurisdictions. Whilst increased transparency and reporting is a positive step for ESG, there are concerns that the heavy demands of reporting may have prompted a diversion of resources from actual sustainability efforts; that companies may allocate significant resources to meet reporting needs at the expense of sustainability initiatives.

The challenge lies in striking a balance between fulfilling ESG reporting obligations and ensuring businesses embed ESG action into day-to-day operations to support the transition to a sustainable future.

Check out insights on regulation from our ESG Gamechangers Summit in London.

2. Data and digitalization

In the early days of ESG investing, data was often scarce and inconsistent, making it difficult for businesses, regulators and investors to make informed decisions. However, driven by increasing demand from investors and businesses for ESG information, ESG data availability has improved. According to Environmental Finance, the ESG data and services market could reach more than $5 billion by 2025 and is projected to continue to grow as investors and businesses increasingly recognise the importance of ESG factors in driving long-term value and sustainability.

There are now a number of standards and frameworks for ESG data, such as the Global Reporting Initiative and the Sustainability Accounting Standards Board (SASB). These standards provide guidance on what information to disclose and how to report it, making it easier for companies to collect and report ESG data. SASB, which is used by many data providers, is available for 77 industries and the standards identify the subset of ESG issues most relevant to financial performance in each industry.

There has also been a marked increase in ESG data providers, including specialised providers, rating agencies, research firms, and data analytics companies. These providers range from large established firms to smaller niche providers. Some of the key providers offer a range of ESG data products, including ESG ratings, indices, research reports, and data feeds. Many providers also offer data analytics and visualisation tools to help investors make sense of the vast amounts of data available.

Along with partnering with established providers who can assist with ESG data, many companies are turning to technology to meet the increased regulatory scrutiny and growing investor and customer demand for transparency. Technology-driven improvements to data digitalization is changing the market in three main ways:

1. Investing in data digitalization results in more accurate ESG data collection and analysis

With improvements in data collection and analysis in recent years through the use of data digitalization (such as the use of AI and machine learning to improve the accuracy of data collection, storage and analysis) companies can better identify areas in their business models and supply chains for ESG improvements. By more accurately measuring their social and environmental impacts, companies can make targeted and impactful changes to improve their ESG track record. Through the ongoing analysis of this data, companies can share these positive improvements with their customers and stakeholders.

2. Improving the strength and accuracy of ESG data through data digitalization allows investors to make better ESG-focussed decisions

Greater digitalization of data leads to a more detailed and accurate set of ESG disclosures which can be made by companies to potential investors. AI Scrubbers are employed to bridge the gaps in corporate disclosures and eliminate subjectivity issues that arise from the information provided by the businesses being analysed. Natural Language Processing tools are used to analyse real-time company information to measure controversies surrounding environmental policies, working conditions and child labour. Further, in recent years there has been a remarkable increase in satellite and sensor data to verify companies' carbon emissions, or to analyse their impact on ecosystems including air pollution, waste production, deforestation, floods. With better disclosure, investors can make greener investment decisions, customers can make informed choices and regulators can streamline their work.

3. Storage of data itself will undergo a green transformation, with greater utilisation of energy efficient data storage methods

Through the use of better data storage technologies such as cloud storage solutions, companies will invest not only in better systems to accurately analyse their data, but also in ways to analyse data in a more energy efficient way. The energy efficiency of data storage was estimated to be 13.6 times greater in 2022 than it was in 2010 and these statistics will only continue to improve with technological improvements. One of the most efficient ways to do this is to reduce the use of individual servers to store data by utilising cloud storage solutions, where large server banks are designed to be used by multiple clients, and are optimised with energy efficiency in mind.

The evolution of ESG data, facilitated by increased digitalization and innovative tools, has ushered in a new era of transparency and accountability. Businesses embracing more detailed and accurate ESG disclosures reflects a collective recognition of the pivotal role ESG factors play in shaping sustainable and value-driven business practices.

3. ESG backlash

Despite the rise of ESG investing, considerable cynicism (particularly in the US) has resulted in a challenge to the global ESG market. This suspicion and pessimism has been coined "ESG backlash". As part of this movement, the phrase "ESG" has become politicised as a hot-button for "woke ideological views" underpinned by arguments that ESG violates consumer rights and anti-trust laws.

In 2023, at least 49 anti-ESG bills have been introduced across the US and there has been concern that investment funds should not be prioritising ESG over financial returns. Where discussion of fiduciary duty within the U.S. tends to emphasize promoting profit, in the EU and UK there is a broader accepted definition of promoting good for all stakeholders of a company. Within the U.S., criticism of misusing fiduciary duty has recently been a particularly politicized issue in relation to public pension funds.

Investment is not the only sphere under which backlash and debate has arisen. The possibility of mandatory climate reporting causes condemnation from anti-ESG campaigners, and this ESG backlash has proponents in Europe as well as the U.S. Recently, there was an attempt to block Europe's ESG reporting rules. Though the block failed, the critics argued it would place a "high administrative burden" on companies. The parallel concerns on both sides of the Atlantic highlights the difficulties of creating compressive and consolidated ESG regulations and reporting requirements. The risk of increasingly onerous regulations means that ESG could be under further scrutiny in the future as companies battle the complications of complying with various frameworks.

There is, however, a distinction between the phrase "ESG" and the underlying principles. This disjuncture between the phrase "ESG" and the various cultural understandings of the phrase adds to a sense of confusion and antipathy to the phrase.

Despite the backlash, money talks. According to Broadridge Financial Solutions Inc, global ESG funds are on track to grow from $8 trillion today to as much as $30 trillion by 2023. Meanwhile, Morgan Stanley reported that sustainability funds saw net positive fund flows of $115 billion, while traditional funds saw sustained outflows.. Some believe that the level of attention given to ESG is a manifestation of the impact it is having. Although talk of ESG backlash might trickle into, or even dominate the debate, the collective interest regarding the term and how it is driven is indicative of its global significance. In this rapidly evolving area, where updates frequently occur, the frenzy whipped up by the anti-ESG lobby remains a powerful counter-force particularly within U.S. politics.

For more discussion on the politicization of ESG, check out our discussion with Karl Racine and Robert Gardener

4. Biodiversity and nature: Why do they matter?

Biodiversity plays a crucial role in sustaining life on Earth, and its significance extends far beyond ecological systems into the realm of business. The term "biodiversity" refers to the variety of life on Earth, encompassing the diversity of species, ecosystems, and genetic diversity within species. Businesses and financial institutions rely on, and impact, nature in everything they do. It is no wonder that biodiversity is a key component of ESG considerations.

But nature is at risk. The World Economic Forum has predicted that half of global GDP is exposed to risk from continued loss of nature and biodiversity. Many industries rely on natural resources for raw materials, water, pollination, and climate regulation. Biodiversity loss can disrupt these ecosystem services, leading to increased operational risks and potential supply chain vulnerabilities. For example, agriculture depends on diverse pollinators for crop production, and a decline in bee populations can significantly impact food production and, consequently, the food and beverage industry.

Moreover, the growing awareness and concern for environmental and social issues have led to a rise in sustainable and responsible investment practices. Investors are increasingly recognizing the importance of businesses aligning with ESG principles, and biodiversity is a key aspect of this. Companies that actively promote and contribute to biodiversity conservation are seen as more resilient, forward-thinking, and better positioned to navigate future challenges related to resource scarcity and environmental degradation.

The rise of nature as an ESG trend is also reflected in the evolving regulatory landscape. Governments and international bodies are implementing policies that emphasize the protection of biodiversity and the sustainable use of natural resources. These regulations aim to hold businesses accountable for their environmental impact and encourage the adoption of sustainable practices. For example:

- The European Union's Biodiversity Strategy for 2030 sets ambitious targets for nature restoration, the protection of ecosystems, and the sustainable use of resources, with implications for businesses operating in or trading with EU member states
- The Taskforce on Nature-related Financial Disclosures (TNFD) published a framework for nature related risk management and disclosure. This encourages disclosure across four pillars: governance, strategy, risk and impact management and metrics and targets
- As part of the UN Decade of Action to achieve Sustainable Development, world leaders have pledged to take urgent action to reverse biodiversity loss in the next ten years

As businesses face increasing pressure to address their environmental impact, integrating biodiversity considerations into corporate strategies becomes not just a moral imperative but also a strategic necessity. The shift towards sustainable and nature-positive practices is likely to continue, driven by a combination of investor expectations, consumer preferences, and regulatory requirements. Companies that proactively incorporate biodiversity conservation into their operations are not only contributing to the well-being of the planet but are also positioning themselves for long-term success in a changing business landscape. We are in a critical period and steps taken now to restore biodiversity and tackle climate change will future-proof businesses and distinguish the leaders from the laggards. While this is a challenge, it can also be viewed as an opportunity. By investing in change now, businesses are setting themselves up for prolonged success.

5. Mitigation measures and technology

In the face of mounting ESG challenges, businesses are increasingly turning to mitigation methods, with a notable surge in their popularity due to the strategic advantages they offer. Beyond regulatory compliance, businesses are recognising that these mitigation methods enhance resilience, improve reputation, and ensure long-term sustainability, thereby contributing to businesses' overall competitiveness in the market.

The adoption of mitigation measures is not solely driven by altruistic motives but is underpinned by the pragmatic realisation that these strategies fortify business models. For example, supply chain transparency, facilitated by technologies like blockchain, is emerging as a critical risk management strategy for businesses. Understanding and demonstrating ethical sourcing practices not only mitigates reputational risks but also responds to the growing demand from consumers for transparent and ethically sound products and services.

There are a wide range of mitigation methods available to businesses, and the market is rapidly developing. A few of the opportunities include:

Carbon Credits

Crucial for businesses, carbon credits go beyond compliance to shape sustainability initiatives. Allocated based on emissions, they incentivise innovative approaches, creating new revenue streams and positioning companies as contributors to a sustainable economy. The financial risk tied to exceeding credit allowances motivates active carbon footprint management. Strategic investments in external offset projects align with consumer preferences, making carbon credits integral for businesses showcasing environmental responsibility in a sustainability-driven market.

Nutrient Neutrality

Nutrient pollution from wastewater treatment and agriculture threatens water-dependent ecosystems. Authorities restrict development in "protected sites," mandating neutralisation of additional wastewater. In the UK, achieving "nutrient neutrality" involves developers offsetting the nutrient load through on-site or catchment-wide measures or participating in the Nutrient Mitigation Scheme, purchasing "nutrient credits" for mitigation obligations and supporting habitat creation.

Green Carbon

Critical for reducing atmospheric carbon, green carbon from land ecosystems faces threats necessitating protection efforts. Legislation mandates supply chain conservation, emphasizing biodiversity, productivity, and support for agriculture. Carbon farming, rejuvenating soil for carbon absorption and credit sales, is a valuable avenue for preserving land ecosystems.

Blue Carbon

Stored in coastal ecosystems, blue carbon faces emission risks from human activities. The blue carbon market is creating opportunities to mobilise additional funds and revenue which align with developments that restore marine environment and improve ocean recovery. The UN's Reducing Emissions through Decreased Deforestation and National Appropriate Mitigation Actions are examples of international carbon mitigation financing schemes offered to developing countries. Meanwhile, proposals like the UK's Marine Net Gain initiative aim to integrate blue carbon projects into markets, fostering sustainable growth in marine industries and aiding ocean recovery by protecting marine habitats.

Across these mitigation efforts, technology plays a crucial role. Advanced monitoring technologies, digital platforms, and data analytics assist in assessing environmental conditions, tracking mitigation progress, and ensuring compliance with regulatory standards. This technological integration enhances the efficiency and transparency of mitigation measures, aligning businesses with the dual goals of environmental stewardship and regulatory adherence.

The overarching importance of these mitigation methods for businesses lies in their pragmatic benefits—they not only assist companies in complying with evolving ESG standards but also fortify companies against risks, enhance competitiveness, and position them as responsible actors in a socially and environmentally conscious market. Technology, as a key enabler of these mitigation strategies, potentially streamlines processes and provides transparency, serving as the backbone for businesses to not only weather the challenges posed by ESG considerations but also thrive in a future where sustainability is integral to success.

For more insights on incorporating nature and TNFD into your strategy, click here to watch our ESG Academy training video.

Conclusion

With so many powerful forces in play, there's no escaping that ESG issues will continue to grow in importance for corporate boards, investors and governments. Alongside that growth will come opportunities and challenges that will need to be addressed through the law, making it critical that in-house teams are ready to respond accordingly.

Resources

Contact us for more information and to help you navigate.

clientesg@Hoganlovells.com

hoganlovells.com/esg

ESG Academy

For more resources on the fastest-moving and most critical issues in the ESG space, visit our free online multimedia training platform

ESG Global Vision & Litigation Guides

Navigate global ESG laws, regulations, and precedent cases with our interactive guides

Alicante
Amsterdam
Baltimore
Beijing
Birmingham
Boston
Brussels
Budapest*
Colorado Springs
Denver
Dubai
Dublin
Dusseldorf
Frankfurt
Hamburg
Hanoi
Ho Chi Minh City
Hong Kong
Houston
Jakarta*
Johannesburg
London
Los Angeles
Louisville
Luxembourg
Madrid
Mexico City
Miami
Milan
Minneapolis
Monterrey
Munich
New York
Northern Virginia
Paris
Philadelphia
Riyadh
Rome
San Francisco
São Paulo
Shanghai
Shanghai FTZ*
Silicon Valley
Singapore
Sydney
Tokyo
Ulaanbaatar*
Warsaw
Washington, D.C.

Associated offices*
Legal Services Center: Berlin

www.hoganlovells.com