Sustainable outlook – Tangible action

2020: Regulation, Climate and Human Rights in the spotlight

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With 2019 drawing to a close, we take a look at upcoming sustainability themes, and discuss which ones are most likely to dominate the markets in 2020. **Although relevant in 2019**, the role of **regulation and policies** will clearly become a top priority in 2020. We anticipate a sharp increase in legislative measures which aim to accelerate the transition to a low carbon economy.

While climate change remains a top priority, a rising number of advocates support a better balance of concerns: In other words, they push for an increased focus on the social cost associated with the fight against environmental issues in general, and climate change in particular. Indeed, the social dimension remains key in ESG analyses. **Human rights** in particular will increasingly become a main topic of concern to stakeholders.

Obviously, **climate change** will continue to dominate debates among investors, regulators and policy makers. Although it has already been a topic of discussion for several years, the main focus has slightly shifted to the **physical risks of climate change, the need for innovation** and the question of **recycling**.

Finally, the **tangible action**. These last few years, we have witnessed the emergence of several initiatives on cooperation, lobbying, investments, shareholders' rights, etc.. Although these initiatives oftentimes successfully spread awareness, they tend to remain abstract in nature. Nowadays, investors and stakeholders are looking for facts and tangible action. It is time to show the practical impact. This also applies to discussions on sustainable strategies and products. The **search for impact and tangible evidence of ESG-achievements** has continuously gained in importance of late. As such, these trends are likely to become of crucial significance to shareholders in years to come.

REGULATION – THE INEVITABLE POLICY

We have witnessed an impressive regulatory acceleration, pushed on by the European Commission and its Action Plan for Sustainable Finance. Lauded as an example of ambitious policy-making, the Action Plan is presented and debated worldwide to encourage global regulatory authorities and policy-makers to take action as well.

Indeed, over the last 15 months, the European institutions have managed to propose a green taxonomy, a regulation on both low-carbon and positive carbon-impact benchmarks, and a disclosure regulation relating to sustainable investments and sustainability risks.

To zero net emissions

Furthermore, the new European Commission has just released its European Green Deal, which forms the cornerstone of its sustainable policies. The new European Commission of Mrs. Von der Leyen will certainly be as active as the Juncker Commission on the topic (if not more so). The Green Deal's first ambition focuses on a carbon border adjustment mechanism for selected sectors. Next, **Europe's first climate law is expected by March 2020, and seeks to achieve climate neutrality by 2050**. In addition, a third initiative enforces higher and more aggressive **decarbonisation targets by 2030**, with an eye on ultimately achieving **net zero emissions**.

The EU's actions have sparked some concern regarding the competitiveness of European companies. This concern is mainly due to the risk of carbon leakages (i.e. the risk of transferring production to other countries due to the relative cost of carbon-pricing schemes). This is a major risk for Europe, as a significant share of its business could shift abroad to avoid the latest ETS regulatory requirements. As of today there are 51 individual carbon pricing schemes in the world. A worldwide consensus-based carbon price is most likely impossible. However, several reputed economists, Nobel Laureates and former chairs of the Federal Reserve have proposed a green border tax and dividend in their "Economists' Statement on Carbon Dividends".

Their main idea encourages **a domestic carbon tax, which is mirrored by a green border tax to ensure that domestic competitiveness remains unharmed**.

The increased involvement of Central Banks: getting serious about climate

Decarbonisation -particularly with a net zero target- requires an acceleration on the policy front. Central banks as well as financial and monetary authorities, which form the very core of the financial system, also have a responsibility to endorse this concept. The Bank of England, France and the Netherlands jointly came up with the **Network for Greening the Financial System (NGFS)** to promote the Paris Agreement. 2019 gave several examples with the leading Bank of England, but also the Netherlands, France and eventually the ECB.

Inevitable policy measures

The awareness and the rising momentum regarding climate issues will lead to increased (and increasingly ambitious) regulation in the near term. In the US, recent discussions indicate that climate change could become a decisive topic in the upcoming presidential elections, which could prove to be another turning point for legislative measures. This is what means the UN-backed Principles for Responsible Investment (PRI) with the Inevitable Policy Response (IPR). Based on the postulate that capital and financial markets are not adequately pricing in carbon risk, the IPR project forecasts a response by 2025 that will be both forceful and abrupt because of previous prolonged inaction.

HUMAN RIGHTS – THE RESPONSIBILITY OF THE FINANCIAL WORLD AS WELL

Climate change has had a noticeable influence on the increasingly-regulated role of the financial world. **We expect that human rights will have a similar impact**. Companies – both financial and non-financial – must be held accountable for potential violations of fundamental human rights. These violations can refer to forced labour, debt bondage, human trafficking and other slavery-like practices.

The Liechtenstein Initiative, the Financial Sector Commission on Modern Slavery and Human Trafficking, was initiated in September 2018. Since then, it has formally recognized the responsibility of businesses with regards to this issue. Their blueprint for mobilising finance against slavery and trafficking (**www.fastinitiative.org**) requires the financial sector to adhere to the following principles:

- **Anti-slavery and anti-trafficking compliance**
- **Responsible lending and investment practices**
- **Financial technology, financial inclusion and regulation models**
- **Responsible business conduct agreements and sanctions regimes.**

CLIMATE CHANGE – MORE GOING FORWARD

Obviously, climate issues will remain one of the most pressing matters in 2020 and beyond.

Regulatory and supervisory authorities have formally recognised the economic risk. As such, the debate is over on whether we should integrate it in financial valuation models. Instead, we should **now focus on how best to integrate this factor**. Currently, assessment models and analyses are constantly fine-tuning their calculations to offer a clearer distinction between physical and transition risks.

Following the overwhelming focus on climate change, our gaze has now turned towards **innovation solutions and investments**. Regarding solutions, the (still-controversial) **carbon capture and storage programs** will become increasingly relevant. Other options will focus on carbon compensation. Nowadays, this mainly refers to **reforestation**, or –to a lesser extent- afforestation. Carbon removal technologies are still in a research-phase, but it is likely that these solutions will become progressively more important in the near future. In order to be scalable, they will require significant financial backing. It is important to keep in mind that these carbon dioxide removal technologies are in no way a fix-all solution. Instead, they serve as a complementary alternative to other green options. As such, they are definitely not an excuse to lessen our efforts on energy efficiency, renewables, emissions cuts, etc.

ACT NOW – IMPACT AND RESULTS

If the modern world is complicated and complex – as posited by Mr. Vladimir Putin to the attention of Greta Thunberg – time and patience are not a solution. **There is a pressing need for an "urgent transition" in the financial system, which is why it is time to act now**. This sense of urgency is similarly reflected in the title of the PRI's global Paris summit in September 2019.

We no longer count the number of initiatives on, not only climate change, but also human rights, supply chain, corporate governance, etc. This impressive number is both positive and promising. However, **the time for new initiatives may be behind us**. Time has come to look at their **results** and to show what **practical benefits** they have brought us.

The same is true for so-called **sustainable strategies**. The time for merely cutting worst-in-class companies out of one's portfolio is over. The search for **ESG impact** (and particularly positive impact) has been more pronounced than ever.

This requires impact assessments and measurements which go **beyond elementary reporting**. Above all, it also requires a plethora of data. Investors are more knowledgeable about sustainability and responsible investments than ever before. Their approaches, methodologies and standards have grown ever more detailed and matured substantially. As a result, it remains **crucial to solve the challenges of ESG data**. ESG data providers are much more confrontational when it comes to the relevancy of their ratings, their engagement with companies and their predictive capabilities. This challenging attitude towards information is a positive evolution, as it promotes accurate data and ethical behaviour. As ESG disclosure eventually becomes a requirement for all companies – both financial and non-financial – it will be important to look at the evolution of the proposed standardized disclosure framework. **The Global Reporting Initiative, the Sustainability Accounting Standards Board (SASB) framework, etc. could become the new norm**. Consequently, investment professionals will likely have to familiarise themselves with these information frameworks.

KEY TAKEAWAYS

- The role of regulation and policies will clearly become a top priority in 2020.
- Climate change will continue to dominate debates among investors, regulators and policy makers. The main focus has slightly shifted to the physical risks of climate change, the need for innovation and the question of recycling.
- Tangible action: the search for impact and tangible evidence of ESG-achievements has continuously gained in importance of late.
- Sustainable strategies: beyond elementary reporting. It remains crucial to solve the challenges of ESG data. Standardised information frameworks could become the new norm.

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