Corporate & Investment Banking

Sustainable Finance and Advisory

Top 10 Sustainability Trends for 2024

The complexity of a global energy transformation and drive for equitable solutions became clear in 2023. As we look to 2024, companies and governments will continue to contend with the real-world challenges and opportunities of achieving their sustainability objectives. Projects across the globe have been challenged by a confluence of macro factors such as inflation, interest rates, supply chains, labor dynamics, and permitting hurdles. However, there may be glimmers of a reprieve in 2024 from the macro storm, while largely supportive government policies, broad investor attention, and maturing technologies are expected to continue providing healthy tailwinds.

The regulatory environment garnered significant attention last year as it became increasingly dynamic and detailed, with the advancement of rules and guidelines likely continuing this year across European jurisdictions, APAC countries, and across U.S. cities, states, and Federal agencies. Emerging areas of sustainability will continue to grow in sophistication, such as nature-based solutions, water management, and the understanding of impacts and reliance upon biodiversity.

Meanwhile, the financial markets will grapple with the nuances of an emerging carbon market, and sustainable finance will surely evolve into new structures to meet issuer and investor needs.

At Wells Fargo, we will remain focused on identifying opportunities to innovate our products and insights to keep pace with the rapidly evolving sustainability landscape impacting our clients.

In 2024, we'll be watching the development of our Top 10 Sustainability Trends below and remain nimble for what's to come. If there is one thing we know for sure in sustainability, there is a never a dull moment.

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Summary of Top 10 Sustainability Trends for 2024

1	**Reality of Approaching Targets Begins to Set In Following Preliminary Net Zero Commitments** Many companies use emissions reduction targets to demonstrate their commitment to sustainability, and 2024 will be a pivotal year in understanding progress towards such targets.
2	**Sustainable Investing: Market Share to Hold Steady; Climate Comes into Focus for Indexes** Sustainable funds experienced diminished flows throughout 2023 due in part to the challenging macro environment. Expect volumes to remain at similar levels with greater investor focus on “Climate” and “Transition” related themes instead of “ESG.”
3	**Consistent Demand for Sustainable Loans Remains Amid Market Volatility** The sustainable use of proceeds and sustainability-linked loan (SLL) market is expected to expand, with 2024 being a significant year for integration of KPIs into credit agreements via an amendment approach (“sleeping” SLLs).
4	**Carbon Markets: A Mixed Bag** While COP28 failed to deliver a global carbon market, voluntary markets are coalescing around emerging principles to establish quality, credibility, and transparency in carbon credits.
5	**Nature: New Vocabulary and Complex Compliance** Nature will continue to garner attention as a developing topic with proposed disclosure frameworks.
6	**Macro Factors Continue to Impact the Energy Transition** The energy transition has faced challenges due to the cost of renewable energy projects, supply chain disruptions, and labor dynamics, which have been compounded by inflation and rising interest rates.
7	**Regulatory Standards Begin to See Global Synchronization, but Detract from Real Economic Progress** Global efforts to standardize disparate sustainability disclosures will likely persist in 2024, while compliance with complex requirements may dampen progress in the real economy.
8	**ESG Ratings Subject to Revision Amid Greater Disclosures and Higher Reporting Standards** As disclosure requirements continue to expand, ESG ratings produced by various companies may face standardization regulations and are expected to evolve.
9	**Measurement of the Ever-Elusive Scope 3 Emissions Gets a Kickstart** Whether the anticipated final SEC Climate Disclosure Rule includes Scope 3 reporting requirements or not, recently-passed California legislation is expected to accelerate the timeline for reporting Scope 3 emissions.
10	**A Monumental Shift is underway in Commercial Real Estate** Commercial Real Estate is beginning to recognize sustainability as a value driver amid high insurance premiums and enhanced building performance standards.

1. Reality of Approaching Targets Begins to Set In Following Preliminary Net Zero Commitments

The depth of the challenge to achieve net zero goals became apparent to many in 2023. Over the past few years, the world's largest companies set longer-term net zero targets, yet the credibility of such targets has recently been called into question.[1] With asset owners and managers increasingly committing to sustainability in their investment decisions and sharpening expectations of corporates, we expect a period of reckoning ahead. Investors, as well as regulators and civil society organizations, are increasingly seeking evidence of concrete actions and transition plans.[2]

The year ahead will be a pivotal check-in year for many companies. According to an analysis of the world's largest companies, the overall robustness of net zero targets and alignment with Paris standards remains low.[3] We may see corporate modifications of target setting across the market in 2024, reflecting not a lack of trying, but rather adaptability to the reality of changing economic conditions, geo-political factors, technological feasibility, and consumer behavior.

Costs and access to quality data will remain a barrier more broadly as corporates work to catch up to their targets. According to a 2023 IBM survey, the management of data represented the top obstacle for corporate Environmental, Social and Governance (ESG) reporting and performance efforts, with executives citing an overload of manual data, consolidation difficulties and data mapping across brands and geographies as key challenges.[4] However, enhanced quantitative reporting and transparency can also provide executives with critical insights to develop actionable decarbonization pathways and uncover meaningful opportunities for value creation. The role of AI in the energy transition will also become more clear in coming years.

Firms can undertake best practices aligned with their respective stakeholders as they pursue their net zero commitments, such as:

1. Provide greater specificity of decarbonization pathways, technologies and adaptations;
2. Align "low emission" thresholds to feasible, scientifically-based decarbonization trajectories;
3. Track regulations, frameworks, GHG accounting, calculations and impact reporting; and
4. Provide transparency to stakeholders about their progress towards interim targets.

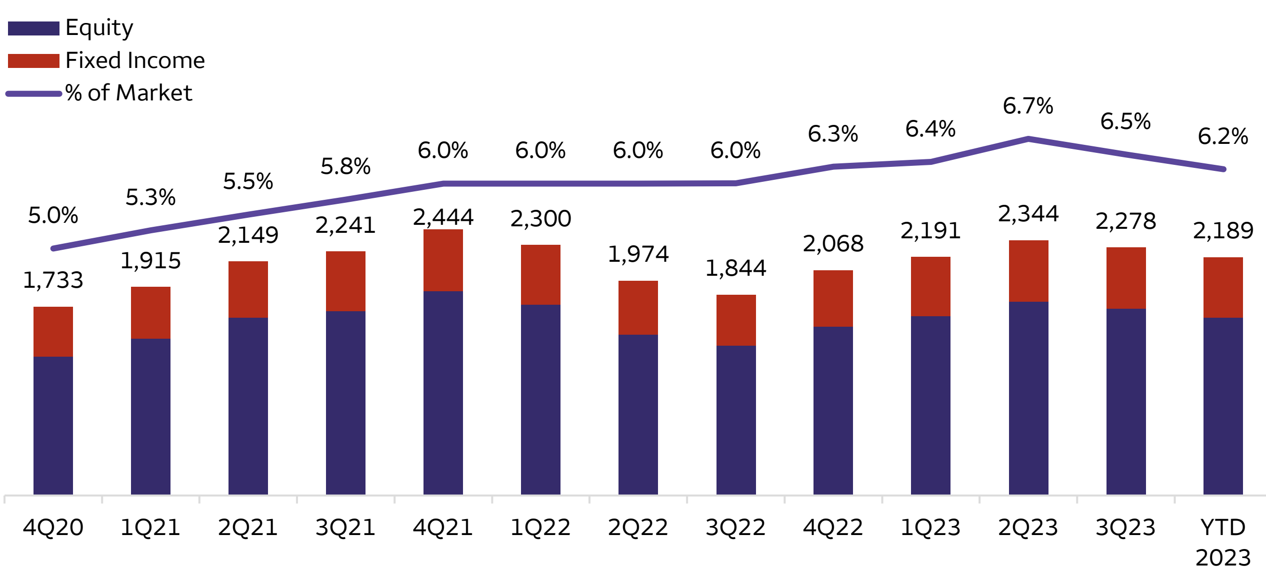
Corporates have the opportunity in 2024 to continue ingraining sustainability into their core strategies and leading the market with more thoughtful targets, enhanced disclosures, and measurable impact, but management teams will be faced with the ongoing task of reconciling today's market challenges with impending commitments.

1. Science Based Targets initiative, "Net-zero ambition 500: companies across the globe committed to leading the science-based net-zero transformation"
2. Climate Action 100, "Key Findings: Net Zero Company Benchmark"
3. Net Zero Tracker "Net Zero Targets among world's largest companies double but credibility gaps undermine progress"
4. ESG Today, "Over 70% of Businesses View ESG as a Revenue Enabler: IBM Study"

2. Sustainable Investing: Market Share to Hold Steady; Climate Comes into Focus for Indexes

Global sustainable funds were a mixed bag in 2023.[5] Fourth quarter notwithstanding, the macro backdrop was challenging for the market as a whole, between inflation, a series of interest rate hikes, and uncertainty around a recession. Sustainable funds were not immune, experiencing more muted flows throughout the year. The stark geographic divide persisted, with Europe showing resilience with continued net inflows in sustainable funds, while the U.S. witnessed outflows. Year-to-date, sustainable assets across Equity and Fixed Income totaled just under $2.2Tn, up a modest 5.8% from the end of 2022. As a percentage of total assets, market share slipped to 6.2% from the record high of 6.7% achieved in Q2'23. For 2024, we expect more of the same – a muted landscape, Europe continuing to dominate, and a market share for Equity and Fixed Income sustainable Assets Under Management (AUM) in the 6-7% range.

Figure 1. Sustainable Equity and Fixed Income AUM ($ billions)



Source: Wells Fargo Securities, LLC.

Sustainable investing funds have evolved from exclusionary/negative screens to thematic, and now to a greater focus on net zero alignment. AUM in sustainability-themed equity ETFs grew 18% in 2023, and the proportion tied to MSCI ESG ratings held steady at ~55%.[6] While ESG ratings will likely remain a common screen, we also see a growing shift by investors to seek quantifiable environmental and social impact, sound corporate risk management, and practical, strategically-aligned transition pathways.

On the debt side, investors remain undersupplied in labeled sustainable finance bonds while asset owner demand persists. This dynamic is supporting modest primary and secondary market benefits for well-structured transactions. These benefits may include incremental investor attention and demand resulting in new issue execution momentum, which can de-risk the capital raising process and potentially lead to pricing or secondary trading benefits. Frothy expectations and exuberant pronouncements regarding the potential growth and impact of sustainable finance have given way to a more 'due-diligence focused' approach from investors, regulators, and the public at large – each of whom continues to view sustainability as a priority.

5. The global sustainable fund universe includes open-end funds and ETFs that, by prospectus or other regulatory filings, claim to focus on sustainability, impact, or ESG factors.

Figure 2: 2023 Sustainable Finance Market by the Numbers

$1.24T in global labeled sustainable finance bond and loan supply (-21% vs. 2022)	**63%** of global labeled sustainable finance bonds and loans in Green format (up from 58% in 2022)	**3.1%** of total USD IG Corporate bond supply in labeled sustainable finance format (~$38 billion in 2023, down from ~6% in 2022)	**26.7%** of total EUR IG Corporate bond supply in labeled sustainable finance format (~€141 billion in 2023, down from 29% in 2022)
+7.9% USD ESG bond fund flows relative to starting AUM - outperforming compared to broader fixed income flows (+4.0%)	**+2.5%** EUR ESG bond fund flows relative to AUM - performing in line with broader fixed income flows (+2.8%)	**2.9bps** median "greenium" observed in November 2023 for USD IG Corp. bond secondary trading	**2.4bps** median "greenium" observed in November 2023 for EUR IG Corp. bond secondary trading

Source: Bloomberg, EPFR, and Wells Fargo Securities, LLC.

Investors are more clearly defining their approaches and utilizing more specific themes such as "Climate" or "Transition" rather than "ESG." Investors are also incorporating labeled sustainable finance bonds in integrated or weighted strategies rather than pure "green bond" funds. Such changes come in response to lack of defined approaches (e.g., what is a "sustainable investment") or to minimize tracking error risk given sector concentrations for both highly-rated ESG names and labeled issuance.

In 2024, we expect issuance to remain at similar or slightly higher levels as corporate sustainability teams mature in sophistication and asset owners (particularly European firms investing across currencies) continue to send the market a demand signal for labeled bonds.

3. Consistent Demand for Sustainable Loans Remains Amid Market Volatility

2023 saw ~$400 billion in global sustainable loan volumes, accounting for 34% of the sustainable finance market.[7] Sustainability-linked loan (SLL) concepts emerged out of the large high-grade corporate market in the early innings of the sustainable finance market but reached a plurality of mid-sized companies in 2023. Some of these enterprises which exhibit nascent sustainability strategies pursued novel concepts focused on sustainable facility utilization. The leveraged loan market also saw sustainable format activity in 2023, with pricing adjustments on SLLs modestly expanded in the pro rata leveraged market as well as in the lower grade asset-based lending market.[8]

With an expected refinancing wave in 2024, the sustainable loan market will primarily be driven by integration of SLL concepts at the time of refinance or amendment, especially the "waking up" of sleeping SLLs, loans that contain ESG language but do not yet integrate established KPIs, which have deeply permeated the market in the past 18 months. A second area of growth is expected to exist in non-public transactions relating to transition finance in the energy sector as well as SLL activity in the fund

6. Bloomberg. Data as of 12/15/2023.
7. Bloomberg. Data as of 12/15/2023.
8. Wells Fargo Securities, LLC

finance market. Lastly, as lenders seek to execute on their financed emissions strategies and seek to comply with relevant regulatory disclosure requirements such as the green asset ratio (as it applies for European lenders), the integration of sustainable formats will likely evolve from opportunistic origination to a key lever to satisfy lender targets.

Catalyzed by recent governmental climate and infrastructure investment regimes, the global syndicated loan market will see continued demand for asset level financing, in structures with and without sponsor recourse, underpinning projects which support ventures ranging from established renewables such as wind and solar to nascent technologies such as new fuels, plastics recycling, and carbon capture. In the U.S., additional Department of Energy Loan Programs Office loans are expected to be committed or disbursed in 2024 related to early-stage, yet-to-be commercialized technologies, carving a path to ultimate scalability. Novel blended finance structures are also expected to be used more frequently, particularly greater use of government project loan guarantees as well as the potential use of municipal conduits for certain assets in the waste, water, and carbon capture space.

Figure 3: Wells Fargo Perspective on Syndicated Sustainable Loan Market

2023 Trends	2024 Considerations	Market Headwinds	Market Tailwinds
• Increased use of company specific metrics and soft demand for ESG ratings use • Heightened lender engagement and diligence • Emergence of market innovations (e.g., sublimits for green spending and green baskets in syndicated commodity finance)	• Flattish volumes • Increased use of proceeds activity • Incorporation of biodiversity metrics • Expansion in fund finance • Increased cross-border appetite from EMEA and APAC lenders for green assets	• Macroeconomic environment • Geopolitical tensions • Climate change apathy • Societal polarization • Green-hushing • Shifts into non-disclosed markets • Materiality of pricing adjustments amid rising interest rate environment	• Loan refinancing cycle • Execution of lender financed emissions and borrower sustainability goals • Continued corporate investment in sustainability improvements • Execution of sleeping SLLs • Regulatory advancements

Source: Wells Fargo Securities, LLC.

4. Carbon Markets: A Mixed Bag

After high hopes for a global UN-sanctioned carbon market, a deal failed to materialize at COP28 over differences largely between the U.S. and the EU bloc. Disagreements centered around the level and role of regulations and how to ensure the integrity, quality and transparency of carbon credits.

Despite the lack of consensus at COP28, significant collaboration between the Voluntary Carbon Markets Integrity Initiative (VCMI), the Integrity Council for the Voluntary Carbon Market (ICVCM) and other organizations resulted in the development of a landmark market integrity framework, establishing voluntary guardrails around quality, transparency and accountability across value chains.[9] The guidance aims to provide rigor around integrity claims in the carbon markets. This framework comes against the backdrop of increased disclosure requirements and the emergence of regulation for the industry.

In the US, the Commodity Futures Trading Commission (CFTC) approved a proposed guidance and request for public comment regarding the voluntary carbon markets. The CFTC stated in their

9. McKinsey “COP28: Climate finance” https://www.mckinsey.com/capabilities/sustainability/our-insights/sustainability-blog/cop28-climate-finance

December press release that their goal "has been to help shape standards in support of integrity, which will lead to transparency, liquidity and ultimately price discovery."[10] The CFTC's interest in the carbon market has raised awareness across current and prospective market participants and may provide a needed boost for the listing and contract design process.

Many financial institutions, national governments and supranational agencies have continued to invest in the growing carbon markets, from payment firms empowering customers to reduce their carbon footprint through the purchase of credits[11] to the World Bank leading a coalition of 15 countries to ensure the integrity and impact of carbon credits generated within these regions.[12] Some corporates are choosing to develop their own projects rather than rely on external providers[13] or make advanced purchase commitments to support the development of early-stage carbon projects.[14]

As the market aims in 2024 to coalesce around quality and integrity standards, we expect to see companies, marketplaces and international organizations continue to develop novel approaches including blockchain and tokenization, use of certifications (such as "silver, gold, platinum"), and insurance. Cross-border cooperation will be critical to implementing a functional carbon market architecture with greater connectivity between the compliance and voluntary carbon markets to enhance liquidity. Oversight, transparency and monitoring will likely be pillars for the carbon markets to rebuild trust and establish market integrity.

5. Nature: New Vocabulary and Complex Compliance

Nature, biodiversity, and water will occupy the minds of most corporate sustainability leaders in 2024 as they consider incorporating nature risks and dependencies into corporate disclosures.

Under the Kunming-Montreal Global Biodiversity Framework, 196 nations committed to halting and reversing biodiversity loss by 2030, including the protection of 30% of the world's terrestrial, inland water, coastal and marine areas and encouraging, enabling, and ensuring corporate nature-related risk disclosures in signatory states. One of such disclosure frameworks is the Taskforce for Nature-related Disclosures (TNFD), which launched its final framework earlier this year. Several large companies have since communicated an intent to disclose a TNFD-aligned report. Based on client feedback, the first corporate TNFD reports may be seen as early as 2025, based on 2024 data. Some first movers have already launched nature positivity commitments, nature strategies and investment plans, and are exploring the Science-Based Targets Network (SBTN)'s guidance for nature.

Practitioners will closely be watching (and in some cases preparing to comply with) a rapidly advancing regulatory regime in the European Union. Unlike the proposed SEC rule focused on climate disclosures, the EU Corporate Sustainability Reporting Directive as well as the European Sustainability Reporting Standards do not stop at GHG emissions-related issues, but also include disclosure requirements

> *"It is clear that we cannot solve [the global biodiversity and climate crises] in isolation – we either solve both or we solve neither."*
>
> \- Sveinung Rotevatn,
> Norway's Climate and Environment Minister

10. CFTC Issues Proposed Guidance Regarding the Listing of Voluntary Carbon Credit Derivative Contracts | CFTC
11. Deloitte "Consumers will increasingly use their wallets to help fight climate change with carbon-offset purchases" https://www2.deloitte.com/us/en/insights/industry/financial-services/financial-services-industry-predictions/2023/financial-firms-carbon-offset-market.html
12. World Bank "World Bank Carbon Credits to Boost International Carbon Markets" https://www.worldbank.org/en/news/press-release/2023/12/01/world-bank-carbon-credits-to-boost-international-carbon-markets
13. Reuters "Carbon credit market confidence ebbs as big names retreat" https://www.reuters.com/sustainability/carbon-credit-market-confidence-ebbs-big-names-retreat-2023-09-01/
14. Sylvera "The State of Carbon Credits 2023" https://www.sylvera.com/resources/the-state-of-carbon-credits-report

related to biodiversity, among others. Notably, the EU approach would require in-scope companies to provide their strategy to achieve no net biodiversity loss by 2030 and full recovery by 2050, alongside other metrics.[15] Foreign companies operating in the EU may be in scope under the regulation in certain cases. Further, the EU recently adopted a landmark, highly-negotiated biodiversity law requiring countries in the bloc to restore 20% of land and sea habitats by 2030.[16] The EU has also implemented the EU Deforestation-free Regulation (EUDR) requiring 'deforestation-free' verification of enterprises trading in cattle, cocoa, coffee, palm oil, rubber, soy, wood, and their derivatives. Such verification is currently challenged by data availability and quality in the supply chain.[17]

The domain of proposed nature disclosure and strategies generally comes down to a few tenets:[18]

1. Natural assets are rapidly degrading globally due in part to unsustainable extraction practices;
2. Natural assets are critical to support the economy with an estimated $44Tn in economic value generation being modestly or highly dependent on ecosystem services;
3. Many companies depend on natural inputs and may contribute to their deterioration – understanding these dynamics should inform risk management and business resiliency practices;
4. Natural capital is undervalued and many now see it as a significant investment opportunity; and
5. Nature plays a critical role in emissions and temperature control and can be a key lever in addressing the climate crisis through enhanced carbon sequestration from nature-based solutions, such as reforestation, agroforestry, and urban ecosystems (like green roofs).

In 2024, Wells Fargo will seek to help companies get situated in the emerging nature and biodiversity discussion and understand how it impacts business strategy, risk management and long-term capital needs. Nature is an issue that resonates broadly. It can stimulate corporate and public engagement, anchor childhood education and help drive understanding of climate change by bringing it down to earth, literally.

6. Macro Factors Continue to Impact the Energy Transition

Efforts to advance energy transition projects and the electrification of value chains globally have been impacted by a macro "perfect storm," but an easing of factors could be on the horizon in 2024.

As inflation and interest rates rose over the last two years, coupled with supply chain delays, project economics were significantly impaired, subjecting projects to cost overruns and cancellations. Renewable energy, in particular, was more exposed to rising costs than traditional energy projects, largely a result of the high upfront investment cost for wind and solar projects, compared to the traditional cost structure of coal- or gas-fired power plant (mostly fuel costs), which are spread over time.[19] Large infrastructure and energy projects also take years to materialize, so those that launched prior to COVID were significantly impacted by macro conditions which had dramatically impacted profitability of projects.

Supply chains have compounded challenges, as the industry continues to manage equipment shortages required for green energy projects. Companies have found themselves re-evaluating the actionability of strategies and taking stock of potential impacts on credit quality. The need to strengthen and shorten supply chains has gained the attention of U.S. private and public sectors alike, pointing to the opportunity for a clean energy–driven manufacturing renaissance.[20] That being said, domestic manufacturing has been

15. European Financial Reporting Advisory Group, "Draft European Sustainability Reporting Standards"
16. European Parliament, "EU Nature restoration law: MEPs strike deal to restore 20% of EU's land and sea"
17. Deloitte, "Food Regulation Highlight: 5 Key takeaways on the new EU Deforestation Regulation"
18. World Economic Forum, "The Future of Nature and Business"; https://www3.weforum.org/docs/WEF_The_Future_Of_Nature_And_Business_2020.pdf
19. The New York Times, "Renewable Energy Could Be a Casualty in the War on Inflation. Here's Why."
20. Deloitte, "2024 renewable energy industry outlook"

stimulated by the Inflation Reduction Act and other federal initiatives, further driven by startups and corporate investment alike, presenting a substantial opportunity for economic growth.

Finally, labor dynamics are playing an important role in the advancement of clean technology, where workers are asserting their role in the multi-faceted transformation of industry, as seen in the 2023 United Auto Worker's strike. Reskilling programs, community activism, and engagement from labor organization, in coordination with various government programs, are expected to play a pivotal role for years to come.

The compounding factors of inflation, interest rates, supply chains, labor dynamics and lengthy lead times for many clean energy projects have created a complex landscape to navigate. However, with inflation cooling, and rate decreases signaled by the Federal Reserve for 2024,[21] we could see the easing of adverse macro factors on energy transition projects. The Inflation Reduction Act, Department of Energy programs and other U.S. federal initiatives will continue to be deployed and spur the scaling of critical technologies. Furthermore, new announcements from COP28 around the renewable energy buildout and the transition from oil, gas, and coal, will likely create a renewed focus on finding solutions in the public and private sectors to expand economically viable energy transition projects. This will lead to greater financing needs and an opportunity to expand sustainable finance across asset classes, a role Wells Fargo is particularly well suited to play.

7. Regulatory Standards Begin to See Global Synchronization, but Detract from Real Economic Progress

Sustainability disclosure requirements have expanded dramatically over the past decade, providing an increasingly challenging landscape to navigate across jurisdictions. Over 1,255 sustainability-based policy interventions have been introduced globally since 2011.[22] In the context of regulatory complexity, many corporates are spending time reconciling a substantial number of diverse regulations such as the EU's Corporate Sustainability Reporting Directive (CSRD), EU Taxonomy and the upcoming EU Corporate Sustainability Due Diligence Directive (CSDDD, or CS3D). The International Sustainability Standards Board (ISSB) announced in June 2023 inaugural standards that seek to create a common language for disclosing the effects of climate-related risks and opportunities on a company's prospects.[23] Furthermore, the ISSB also incorporated TCFD recommendations into its reporting standards to further drive simplification.[24] Increased adoption of ISSB could potentially harmonize and reduce the number of disclosures corporates must undertake.

ISSB is climate-centric, focused on general disclosures and climate change. In the EU, regulations such as CSRD and CSDDD have a focus broader than climate, seeking to encompass a more full spectrum of ESG. This begs the question of how ISSB will solve for the harmonization across regions to promote comparability at the global level. Further developments may come in 2024 from the European Union, where climate rules and their implementation may be simplified.

In the U.S., there has been divergent approaches to climate-related disclosures. Some states that have Democratic legislative majorities, such as California and New York, have taken action to enhance climate-related disclosure and/or drive clean energy investments.[25] At the federal level, there have been some proposals on GHG emissions and climate-related financial risks disclosures from the Department of Defense, General Services Administration, NASA and the SEC.[26]

21. The New York Times, "Fed Leaves Interest Rates Unchanged at Meeting and Signals 3 Cuts Next Year"
22. ESG Book, "Global ESG regulation increases by 155% over the past decade."
23. IFRS, "ISSB issues inaugural global sustainability disclosure standards"
24. IFRS, "ISSB and TCFD"
25. New York State, "New York State Climate Action Council Finalizes Scoping Plan to Advance Nation-leading Climate Law", California State, "California Climate Commitment"
26. Federal Register, "Federal Acquisition Regulation: Disclosure of Greenhouse Gas Emissions and Climate-Related Financial Risk"; U.S. Securities and Exchange Commission, "SEC Proposes Rules to Enhance and Standardize Climate-Related Disclosures for Investors"

The broad efforts to standardize disclosures – while important for transparency purposes – can have the unintended consequence of distracting from real-world economic progress and environmental/ social impact. Corporates are juggling rules and requirements that differ across jurisdictions, requiring a considerable deployment of expert resources for compliance. The complex regulatory expectations may be subduing sustainability ambition and may ultimately constrain actual progress in the real economy. We expect that regulatory consolidation and streamlining will continue in 2024, hopefully with an eye for reducing complexity and focusing on real economy progress.

8. ESG Ratings Subject to Revision Amid Greater Disclosures and Higher Reporting Standards

ESG ratings came to prominence as a tool to assess a company's management and mitigation of non-financial issues which, if not managed, can adversely impact corporate performance. Product safety, climate change adaptation, pollution prevention practices, energy efficiency, employee health, diversity, equity, & inclusion, and human rights have, in various ways, impacted corporate bottom lines. Investors have sought to understand these risks in their portfolios and utilized ESG ratings produced by various providers in the market as part of their analysis.

As understanding of ESG-related risks continues to develop, the ESG ratings landscape will necessarily evolve. In the wake of more stringent reporting frameworks and regulations globally, the level of corporate disclosure has expanded. Along with increased investor scrutiny, corporate issuers are responding with more data-driven approaches to disclosure and risk management. The enhanced disclosure will likely lead to an ongoing refinement of ESG ratings approaches and is expected to lead to greater differentiation among corporates.

The topic of ESG ratings is already a complex one, with corporate issuers and investors contending with disparate methodologies across raters. One study found that the correlation between the leading providers' scoring of the same company can be as low as 0.54, compared to a correlation of 0.99 between traditional credit ratings of the same company.[27] Calls for increased standardization and transparency have led to the emergence of proposed ratings regulations. Most recently, the EU published a proposal for ESG ratings regulation which aims to enhance the "integrity, transparency, governance and independence of ESG ratings provided in the EU" by requiring providers to maintain independence. "Independence" is defined as providers not being able to offer other services like credit ratings, benchmarks, consulting, audit, investment activities, insurance, or banking. Agreement on the final regulation is expected in mid-2024 and it would take effect six months later.[28]

As regulatory expectations become more clear and disclosure data quality improves, we foresee further consolidation within the ratings and broader climate-tech space. Several large financial companies have looked to expand their ESG data offerings through M&A in recent years. Institutional Shareholder Services has purchased four separate ESG data and research providers since 2015. Moody's Corp. struck three separate ESG deals in 2019 alone, including acquisitions of Vigeo Eiris, Four Twenty Seven Inc. and a minority stake in SynTao Green Finance.[29] And MSCI, S&P Global, DBRS Morningstar and the London Stock Exchange Group have each announced several ESG-related purchases of their own.[30] Ultimately, the ESG ratings landscape will continue to evolve as investors incorporate the growing body of public disclosure into their holistic investment analysis. S&P Global Ratings demonstrated this theme by announcing in August that it would no longer publish new ESG credit indicators in its reports or update outstanding ESG credit indicators, but rather incorporate material risks into its core credit analysis. Whether other credit agencies will also evolve remains to be seen, but 2024 will likely continue to show a normalization of ESG-related disclosures into financial evaluations across a wide range of use cases.

27. MIT Sloan and University of Zurich, "Aggregate Confusion: The Divergence of ESG Ratings"
28. KPMG, "ESG ratings — the EU's journey to regulation begins"
29 S&P Global, "Consolidation among ESG data providers continues amid COVID-19 pandemic"
30 London Stock Exchange Group, "London Stock Exchange Group acquires Beyond Ratings"

9. Measurement of the Ever-Elusive Scope 3 Emissions Gets a Kickstart

With the passing of legislation in California in early October mandating climate-related reporting, the timeline for Scope 3 emissions reporting has immediately accelerated. Many were quietly expecting disclosure requirements in the U.S. to focus on Scopes 1 and 2 emissions for the time being, pending clarity on Scope 3 emissions. Even the SEC has been stalled on its proposed Climate-Related Disclosure Rule, with particular discussion around Scope 3 disclosure. The California disclosure rules are quite ambitious, with similarities to the EU regulations, thereby tacitly advancing in-scope companies' reporting obligations as we await finalization from the SEC. The clock is ticking—starting in 2027, U.S. companies with significant revenue that are, "doing business" in California, are expected to disclose their Scope 3 GHG emissions data as part of the Climate Corporate Data Accountability Act (SB 253); reporting for Scopes 1 and 2 will be required a year earlier, in 2026. The impact is expected to be far-reaching, as the law applies to both public and private companies with total annual revenues in excess of $1 billion that conduct business in California. The sister law, SB 261, requires "covered entities" with annual revenues >$500 million to publicly disclose their climate-related financial risks in accordance with TCFD recommendations, and any measures they have adopted to mitigate and adapt to those risks. Those reports must include climate-related vulnerabilities concerning their employees, supply chains, consumer demand, and shareholder value, among others.[31]

Figure 4. Select Disclosure Developments and Associated Timelines

GHG Emissions Reporting	SB 253	SEC	CSRD	ISSB
First Reporting	Jan. 2026	TBD	Varies based on entity structure, earliest reporting is Jan. 2025	Effective Jan. 2024, subject to jurisdictional mandate
Company Scope	Public and private companies that do business in CA with a total annual revenue over $1 billion	Public companies	Public and private companies	Subject to jurisdictional regulatory adoption by countries
Scope 1 & 2	Required	Required	Required if material	Required if material
Scope 3	Required beginning in 2027	Required if material in initial proposal, pending final rule	Required if material	Required if material
Assurance	Limited assurance for Scope 1 & 2, moving to reasonable assurance in 2030. Limited assurance for Scope 3 beginning in 2030.	For certain registrants, limited assurance on Scope 1 & 2, moving to reasonable assurance after two years. No assurance for Scope 3.	Limited assurance on all sustainability information from first year of reporting. Reasonable assurance likely required further down the road.	Subject to jurisdictional regulation

Source: California Government, U.S. Securities and Exchange Commission, International Financial Reporting Standards, and Deloitte.

31. Morgan Lewis, "California Requires Companies to Disclose Climate Change Risks, GHG Emissions"

The California laws come as good news for stakeholders seeking more detail and metrics from companies; this past proxy season did see an uptick in shareholder proposals on corporate value chains. And by leapfrogging the SEC's Climate-Related Disclosure Rule, which has been delayed numerous times (expectations now set for April 2024), they kickstart any pending Scope 3 disclosure processes. Certain companies have been proactively supporting the decarbonization of their supply chain through formal programs and outreach efforts. In Europe, demonstrating a similar emphasis, the CSRD's foundational concept of "double materiality" centers around understanding risks and impacts across corporate value chains and key stakeholders.

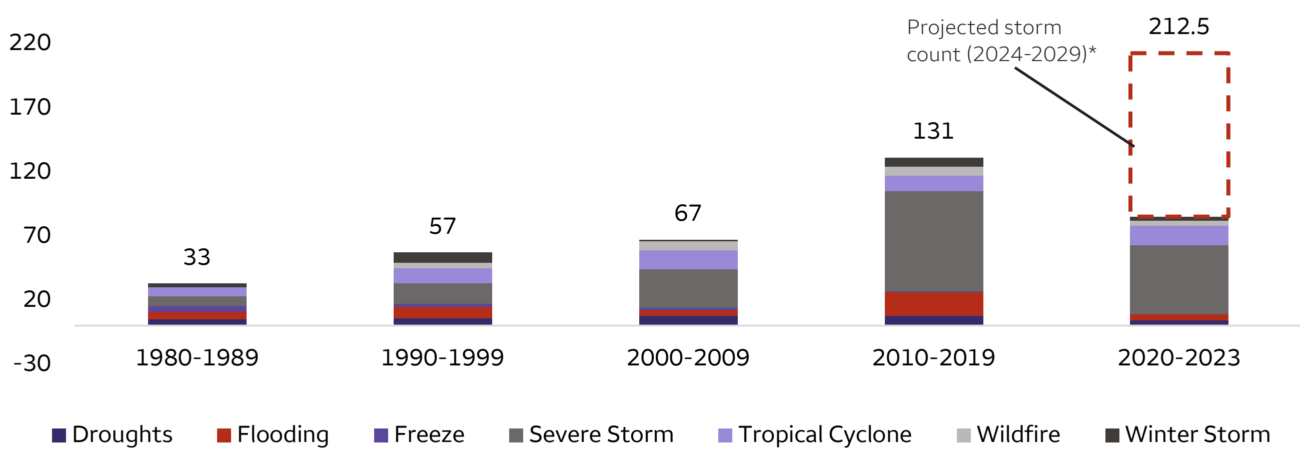
Scope 3 emissions and other value chain assessments will continue to be a challenge, but with increased focus by regulators, consumers, and investors on quantifiable impact, measurement and tracking methodologies are bound to improve, as are the business strategies that underpin them. By incorporating sustainability across the value chain, companies can get ahead of impending expectations and maybe even unlock tangible long-term value for their franchise.

10. A Monumental Shift is underway in Commercial Real Estate

The real estate industry is poised for a monumental shift in thinking, building, and operating. Real estate operators need to consider the emerging risks and opportunities of a fully-integrated and well-formulated sustainability strategy.

Years of insurable losses due to storm frequency and severity are starting to hit landlords in the pocketbook with double digit premium increases across all property types in 2023. Through October 2023, there were over $50 billion of insurance losses from severe convective storms in the United States, representing approximately 60% of global losses. If severe storms continue to drive insurance losses, reduced coverage availability and higher premiums could meaningfully impact net operating income (NOI) and property valuations. In 2024, real estate operators should expect that stakeholders will require a more thorough assessment of physical climate exposure with an eye towards risk mitigation.

Figure 5. Severe Weather Events since 1980 (Historical and Projected)



* Linear projection based on average annual storm count from 2020 - 2023
Source: FHS Risk and Wells Fargo Securities, LLC.

Building performance standards ("BPS") are also getting real. January 1, 2024 will mark the official commencement of New York City's local law 97, which imposes annual GHG emissions caps depending on the building's specific use, with the caps getting stricter over time to achieve an 80% reduction in GHG emissions over a 2005 baseline. Residential and commercial buildings that fail to comply will be subject to fines and penalties. According to Bloomberg, projected fine exposure in 2024 is forecasted to be modest with only 11% of building anticipated to be out of compliance; however, fine exposure is projected to increase substantially beginning in the 2030 compliance period with up to $900 million of annual fines (assuming no further intervention by 2030). New York City represents only one of 45 members of the National Building Performance Standards Coalition, a nationwide group of states and local governments that have committed to inclusively design and implement building performance policies and programs in their jurisdictions with the goal of adoption by Earth Day 2024 (for the first cohort).[31] This is in many ways the U.S. playing "catch up" with its European brethren across the pond. There continues to be a push for policy augmentation in the EU with lawmakers in the European Parliament and Council recently announcing they have reached a provisional agreement to strengthen the EU's Energy Performance of Buildings Directive (EPBD), aimed at reducing energy use and emissions in buildings. The revisions include a required phase out of fossil fuel boilers by 2040, as well as a target for all new buildings to be zero emission by 2030. With the proliferation of legislation across the globe aimed at decarbonizing real estate, there is urgency for owners, investors, and lenders to evaluate net zero transition plans.

The sustainability discussion in commercial real estate is also shifting from one focused primarily on expense savings to now one focused on being a revenue driver. There are three primary means for achieving revenue growth tied to sustainability:

1. The Green Premium. Net zero aligned occupiers must find sustainable real estate and are increasingly willing to pay a premium.

2. Solar for the win. In states with high energy costs, there are potentially several ways for landlords to monetize solar options such as a rooftop lease to a solar company. These leases can provide additional revenue for 10-25 years and building owners may also be able to front load benefits due to the many tax credits and incentives available for renewable projects.

3. Electric Vehicle (EV) charging stations represent another avenue for landlords to achieve new revenue sources. EV charging stations turn a single parking space into a fuel station that can generate revenue 24-hours per day. Landlords can charge per kilowatt hour, or as an additional monthly fee included in a residential or commercial lease agreement. The icing on the cake is that governments at all levels and even local utility companies are encouraging adoption with tax credits, incentives, grants, and rebates.

In 2024, the real estate industry will undoubtedly hope to find stabilization in the capital markets and continue evolving based on external forces. Although the chapter on new 'norms' is still being drafted, it is safe to assume that sustainability will prominently be on display.

32. National BPS Coalition, "About the National BPS AddeCoalition"

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