Millani's 2022 MarketTrends

February 17th, 2022

2021 saw many targets and commitments made by investors, corporate issuers, governments, and regulators on ESG-related topics. We believe 2022 will be the year that promises, commitments, and targets evolve into action.

As trusted advisors to investors, corporate issuers, Boards of Directors and capital market participants, Millani offers a unique perspective on the rapidly evolving field of ESG integration and sustainable finance.

Read Millani's insights on the most significant ESG integration trends for 2022 and beyond.

Inflation will have far-reaching implications

ESG issues are business issues. One key issue that is top of many minds is inflation. As of January 2022, most developing countries, including Canada and the US, are experiencing rising levels of inflation. The causes and effects of inflation are highly connected to environmental (E) and social (S) issues – making them key business issues. Here's why:

1. The S: Labour conditions and changing consumer habits continue to affect inflation rates

The pandemic has influenced both consumer spending habits and labour conditions. Household spending had already begun to increase before the COVID-19 pandemic hit, and today, demand for goods is approximately 18% higher than in 2019.[1] However, low pay, poor working conditions, and a change in outlook have led to "The Great Resignation", reducing capacity to supply goods. Thus, manufacturers, distributors and suppliers face the twin challenges of increased demand and supply chain issues. Higher costs are being passed on to the consumer and are apparent in the rising prices of food, transport, and housing.

2. The S: Inflation may exacerbate existing income inequality

Economists have found that lower-income earners may face higher inflation rates than top earners do, further widening the gap between higher and lower income populations.[2] As income inequalities increase, social unrest may result, shifting government spending towards pressing social issues, and notably, away from the energy transition.

3. The E: Inflation is linked to climate change

Canada aims to transition its economy and achieve Net Zero emissions by 2050.[3] RBC estimates that this transition could require $2 trillion in financing over the next 30 years.[4] Projects needed to facilitate the transition will likely increase in price due to rising interest rates and supply chain issues. What's more, natural catastrophes associated with the effects of climate change highlight the need for government spending on infrastructure. Recent stress tests estimate that up to 18% of global GDP could be lost by 2050 if little to no climate action is taken, with an estimate of a 10% loss in Canada's GDP.[5]

Inflation is complicated. It is highly connected to many facets of our economy. It is raising doubts about the ability to finance the transition to a lower-carbon economy, and represents future volatility for the markets.

Sustainable finance will professionalize further

In 2021, we saw a movement from ESG to sustainable finance. Meaning, we went from a portion of the market integrating ESG, to the whole of the financial sector and ecosystem considering environmental, social and governance topics in their business practices.

In Canada alone, sustainable fund assets grew by 143%,[6] a Net-Zero Advisory Board was formed,[7] and sustainable bonds started to trade on the TMX. Climate Engagement Canada was launched, the Sustainable Finance Action Council (SFAC) was formed, and in January 2022, OSFI and the Bank of Canada published a report highlighting the fact that Canada's financial institutions are at risk of "sudden and large losses" as the global economy transitions from carbon emissions, mostly driven by declines in global commodity prices.[8] The Canadian Securities Association (CSA) has also been working on ESG disclosures, providing guidance on disclosure practices for investment funds[9] and requesting guidance on its consultation on mandatory climate disclosures for issuers.[10]

Alternative finance

Alternative finance is moving into ESG too. One study showed that 72% of private equity firms always screen target companies for ESG risks and opportunities at the pre-acquisition stage.[11] ESG risks and opportunities typically represent longer-term considerations.

1. Omicron fears dramatically reduced travel spending over the holidays, RBC Consumer Spending Tracker, January 2022.
2. The Missing Data in the Inflation Debate, The New York Times, December 30, 2021.
3. Net-Zero Emissions by 2050, Government of Canada, January 14, 2022.
4. The $2 Trillion Transition: Canada's Road to Net Zero, RBC, October 20, 2021.
5. World economy set to lose up to 18% GDP from climate change if no action taken, reveals Swiss Re Institute's stress-test analysis, Swiss Re Group, April 22, 2021.
6. Global Sustainable Fund Flows: Q3 2021 in Review, Morningstar, October 2021.
7. Net-Zero Advisory Body, Government of Canada, November 4, 2021.
8. Bank of Canada/OSFI pilot helps Canadian financial sector assess climate change risks, Bank of Canada, January 14, 2022.
9. CSA Staff Notice 81-334 ESG-Related Investment Fund Disclosure, Canadian Securities Administrator, January 14, 2022.
10. Canadian securities regulators seek comment on climate-related disclosure requirements, Canadian Securities Administrator, October 18, 2021.
11. Private equity's ESG journey: From compliance to value creation, PwC, May 2021.

Given a longer average holding period than public markets (five years versus 5.5 months),[12] and direct shareholder influence, private capital is well aligned to address ESG topics, mitigating downside risk and capitalizing on upside opportunities.

Alternative finance approaches, such as blended finance (the use of capital from public or philanthropic sources, to increase private sector investment in sustainable development),[13] are expected to grow. With the global Net-Zero Asset Owners Alliance putting out a call to asset managers to develop blended finance vehicles in 2021, we expect to see more projects using blended finance for the energy, infrastructure, and real estate sectors.

A tale of two transitions

With a need and demand to rebuild the economy following the effects of the COVID-19 pandemic, global leaders are seeing the transition to a lower-carbon economy as the foundation of that rebuild. In its latest analysis, the International Renewable Energy Agency (IRENA) estimates that cumulative investment in renewable energy needs to reach US$27 trillion in the 2016-2050 period.[14]

To meet some of these estimates, this can't just be a transition of the energy sector, it must include the financial sector too. Leaders in the market have even started to offer "transition funds" that support the financing of businesses shifting towards lower-carbon products or services.[15] This contrasts with divesting away from e.g., oil and gas companies. A key part of accessing transition financing will be the ability to demonstrate action, rather than simply make commitments.

This transformation is no longer a choice for financial institutions. It will continue at the same speed, or faster, in 2022. To support this, regulation is needed as it will provide guardrails to this movement, with the caveat that extreme regulation may dampen creativity and momentum.

Requirements for ESG data will become more complex

To carry out this transformation, financial organizations need data. When asked what their top three challenges were, 61% of investors mentioned the availability of data.[16] However, a Carbon Tracker study discovered that 70% of companies who made climate commitments did not consider climate matters when preparing their financial statements. The study also found that 72% had inconsistencies in climate disclosures across their disclosure documents, and that 80% of auditors provide no indication of whether or how climate-related matters are considered.[17]

Investors are expressing that they find this discrepancy concerning. Expectations are likely to change, with more pressure to represent ESG-related liabilities in dollar amounts on balance sheets, not just in the risk sections of Annual Information Forms. To start quantifying financially material ESG risks and opportunities, standard setters will need to create reporting guidance.

In November 2021, the formation of the International Sustainability Standards Board (ISSB) was announced, resulting from a merger of the Sustainability Accounting Standards Board (SASB), the Integrated Reporting (IR) organization and the Climate Disclosure Standards Board (CDSB). This will become a key driver for issuers as it will require the collection and management of ESG information so it can be audited and verified before disclosing. What was once considered a "nice to have" is now becoming fundamental to safeguarding from key risks and identifying areas of opportunity and value creation.

People will facilitate the transition

Talent is key to any business. The conditions of the COVID-19 pandemic, which provoked "The Great Resignation" and further social instability, mean that talent is now an especially critical topic to consider.

12. Buy, sell, repeat! No room for 'hold' in whipsawing markets, Reuters, August 3, 2020.
13. Blended Finance, Convergence.
14. Global energy transformation: A roadmap to 2050, International Renewable Energy Agency, April 2019.
15. Green Municipal Fund, Federation of Canadian Municipalities, 2022.
16. Millani's Semi-Annual Investor Sentiment Study, Millani, to be published in February 2022
17. Flying blind: The glaring absence of climate risks in financial reporting, Carbon Tracker, September 2021.

As employee attrition and demand for goods grow, most industries face talent shortages. A recent study highlights that 40% of employees were at least somewhat likely to leave their current job in the next 3-6 months,[18] and CEOs are also leaving their positions. In the last quarter of 2021, CEO departures were up 16% year over year, with burnout frequently cited as the primary reason.[19]

Culture is a key part of being able to attract and retain employees. In 2022, we expect issuers will focus more on communicating their culture in order to provide investors with a deeper view into their organizations.

2022 will also see a focus on developing ESG expertise. Toronto Financial International's recent survey shows that Canada's financial industry needs a skills upgrade regarding ESG, with 95% of respondents expecting that current employees will be "upskilled to contribute to sustainable finance mandates within the organization".[20]

It is time to consider how your teams will deliver in this fast-paced sector. Given the push for management teams to purposefully manage the health and wellness of their talent, and to track quality data around this topic, be prepared to both disclose and engage more frequently on this topic.

Other ESG topics will rise on the radar

Indigenous Peoples will have a key role to play in the transition

With the recognition of the need for reconciliation with Indigenous Peoples around the world, the benefits of working together are becoming increasingly apparent, especially when it comes to the transition to a lower-carbon economy. One investor shared that "for the Net Zero transition to happen, every project will require support from Indigenous Peoples".[21]

The Responsible Investment Association's Investor Opinion Survey noted that 70% of respondents want Canadian companies in their portfolio to partner with Indigenous Peoples on decisions around future energy transitions.[22] To note, the UN Declaration of Indigenous Peoples (UNDRIP) received Royal Assent and came into force in Canada in June 2021.

Biodiversity disclosure requirements will evolve

Nature capital disclosures evolved at a fast pace in 2021, with many announcements expected in 2022:

- The Taskforce on Nature-related Financial Disclosures (TNFD) is currently in development, with a beta version expected in Q1 2022.[23]
- The European Financial Reporting Advisory Group (EFRAG) announced that it will collaborate on its biodiversity proposals with the Global Reporting Initiative (GRI), and will be updating its Biodiversity Standard in 2022.[24]
- In November 2021, the CDSB published a framework for biodiversity information, which will be integrated into the ISSB standards development.[25]
- Nature Action 100, following in the footsteps of Climate Action 100+, is expected to launch in early 2022.

Water also presents a risk to investors, issuers, and society. In Canada, we sadly have become highly aware of the impacts of water stresses and droughts, with far-reaching impacts on people and the economy. The Insurance Bureau of Canada estimates that the extreme flooding in British Columbia in 2021 represented insured damages of roughly $450 million, and that it was the "most costly severe weather event in the province's history."[26] Millani has shared insights on how to assess water, as part of the Palgrave Studies in Sustainable Business in Association with Future Earth series.[27]

18. 'Great Attrition' or 'Great Attraction'? The choice is yours, McKinsey & Company, September 8, 2021.
19. CEOs are joining the 'Great Resignation' trading fatigue for family time, NBC news, January 18, 2022.
20. Taking the lead in sustainable finance: A case for developing critical financial skills and competencies in Canada, Deloitte and TFI, January 2022.
21. Millani's Semi-Annual Investor Sentiment Study, Millani, to be published in February 2022.
22. 2021 RIA Investor Opinion Survey – Canadian Investor Perspectives on the Energy Transition, RIA, November 2021.
23. Nov-Dec newsletter: TNFD shares 2022 expectations, TNFD, December 17, 2021.
24. EFRAG and GRI to co-construct biodiversity standard, GRI, December 1, 2021.
25. CDSB Framework: Application guidance for biodiversity-related disclosures, CDSB, November 2021.
26. B.C. floods estimated to cost at least $450M, with uninsured damages raising amount further, National Post, December 2021.
27. Water Risk and Its Impact on the Financial Markets and Society, Walker et al, Palgrave Macmillan, 2021.

Cybersecurity & data privacy concerns will continue to rise

The first half of 2021 saw a rise of 151% in global ransomware attacks in comparison to the first half of 2020.[28] With the estimated average cost of a data breach being CAD$6.35 million,[29] this is a financially material risk on many management teams' minds. In North America, 69% of CEOs are extremely concerned about cybersecurity threats and the danger it poses to organizational growth, ranking it as the top threat, above over-regulation and pandemics.[30] Mandatory disclosure requirements are expected from the U.S. Securities and Exchange Commission (SEC) in 2022.

Key takeaways

Going forward, we expect increased volatility and unpredictability, leading to more vulnerabilities for issuers and investors alike. Although the focus may change, the topics of climate change, human capital, and ESG data availability will remain high on the priority list for 2022.

With regulation changes, demand for ESG information growing from investors, employees, governments, and other stakeholders, and the likelihood of mandatory disclosures increasing, it's never been more important to understand your material ESG risks and opportunities. Now is the time to develop communication strategies, engage with your stakeholders, and own your ESG story.

This report is a summary of Millani's 2022 MarketTrends. For further information on what these trends might mean for your business, please reach out to info@millani.ca.

About Millani

Millani provides advisory services on ESG integration to both investors and companies. For the past 14 years, Millani has become the partner of choice for institutional investors. By providing advisory services on integrating material ESG issues into their investment strategies and decision-making processes, we help our clients reduce risks, increase returns, and create value. Millani is also leveraging this expertise and its experience in ESG consulting to help reporting issuers improve their ESG disclosure to financial stakeholders and optimize their market value.

For more information, contact us at: info@millani.ca or visit our website: www.millani.ca.

28. Cyber threat bulleting: The ransomware threat in 2021, Canadian Centre for Cyber Security, December 9, 2021.
29. The Cost of a Data Breach Report 2021, IBM, July 28, 2021.
30. 24th Annual Global CEO Survey: A leadership agenda to take on tomorrow, PwC, June 2021.