THE ESG CONVERSATION
Strategies for a sustainable future

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THE 'BRUSSELS EFFECT' GOES GREEN: HOW THE EU IS SEEKING TO SHAPE THE GLOBAL ESG REVOLUTION

The "Brussels effect" in ESG

The EU has done it before: most prominently with the GDPR (General Data Protection Regulation), Brussels set the global standard applied by corporates operating worldwide. Now, the EU is seeking to apply the "Brussels effect" to the green transformation. Given Europe's leadership on ESG investing, its determined Net Zero Policy, progressive climate court rulings, and broad voter support, the EU is well positioned to shape the global standard yet again, this time for ESG (Environmental, Social, and Governance factors).

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Green Deal, Taxonomy, Fit for 55 & Co.: The EU's green regulatory agenda

In two consecutive weeks in early July, the European Commission has presented two comprehensive policy packages aimed at all aspects of ESG: one on Sustainable Finance, the other, "Fit for 55", on decarbonizing industry by 55% percent (compared to 1990) until the end of the decade. In addition, reforms on corporate governance and supply chain accountability are expected to follow until the end of the year and will complement the EU's efforts also on the 'S' and 'G' dimensions of ESG.

- The EU's framework for **Sustainable Finance** has the potential to significantly accelerate the trend towards the 'greening' of capital markets. For instance, the EU plans to expand the Taxonomy for Sustainable Finance to eventually include virtually all economic activities, categorizing them in those that contribute to (positive taxonomy) or harm sustainable goals (negative taxonomy). Based on this and other ESG metrics, companies and their financiers will be fully exposed due to binding disclosure and reporting standards, obligatory climate stress tests for banks and insurers, and newly standardized ESG ratings, among others.

- For industry, the **'Fit for 55' package**, will redefine the economics of key sectors through a range of measures, most importantly a re-pricing of emissions through a sharpened and expanded Emissions Trading System (ETS). For cars – just to mention one sector as example – the new rules bring a de facto ban of diesel and petrol cars by 2035. For global trade, the introduction of a first-of-its-kind carbon levy at the EU's border (the "Carbon Border Adjustment Mechanism") is set to raise the prices of a select basket of imports in some of the most carbon-intensive industries, creating disruptions for globally operating businesses.

Both packages – Sustainable Finance and Fit-for-55 – mutually reinforce each other. Together, they create a spiral of pressure on corporates to transform their business. Both follow the logic of ESG that investments and economic activities are not to be evaluated on financial returns (and risks) alone, but more than ever on Environmental, Social, and Governance factors. Companies' individual efforts (or lack thereof) to get "fit-for-55" will be made brutally transparent for investors in the EU's Sustainable Finance framework.

> To implement Europe's unprecedented decarbonization plans, markets will be shaped by the "visible hand" of governments, and EU regulators in particular. Companies should embrace this and engage with policymakers to shape their own sector's green transformation, ideally gaining a competitive edge.
>
> Julian Jacobitz

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Implications for board rooms

The number of times "ESG" was mentioned in companies' earnings calls has exponentially increased over the last few quarters. As analysts are beginning to integrate the implications of the EU's policy measures for industries and individual companies, boards need to take a bold look at the future of their businesses against this rapidly changing environment.

Companies may have already adopted science-based targets (SBT) for their decarbonization paths, in anticipation of such policies as the EU's Fit-for-55 package. But as the proverbial saying goes: "the proof of the pudding is in the eating". The unprecedented degree of transparency brought by the EU Sustainable Finance framework will multiply the needs for companies to show concrete results, for example by demonstrating increasing alignment of activities with the EU's Taxonomy.

> **"The demands on corporates to drive ESG-led change comes from 360°:** investors, NGOs, policy makers, regulators, employees, and the broader public. The sooner corporates align their green transition strategy with coherent 360° communications towards these stakeholder groups, the more credible and impactful they will be."
>
> Biancastella de Angelis

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Boards – together with their strategy, business, communications and policy departments – will have to chart their individual companies' course. Being a leader in the transformation might require board-led processes such as reviewing a firm's business model, developing a new strategy, building awareness for the transformation and its trade-offs, mobilizing employees, and building resilience in view of activism. Last but not least, it will require strategic communications that secures key stakeholder support for such processes and prepares the ground for transformative strategic decisions.

Our Government Relations and Public Affairs advisors in Brussels and European capitals as well as our ESG experts across our global offices are looking forward to continuing "the ESG Conversation".

CONTACT

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Overview of Sustainable Finance Strategy:

- Extension of the EU Taxonomy to recognize transition efforts, and to cover economic activities that significantly harm the environment
- Extension of the EU Taxonomy to progressively include almost all economic activities
- Adjust sustainable finance standards and labels to finance transition efforts
- Capture of ESG risks in credit ratings and rating outlooks
- Amendments of prudential banking regulation to include ESG factors in financial risk management systems
- Integration of sustainability risks in the prudential framework for insurers
- Reinforcement of science-based target setting, disclosure, and monitoring of financial sector's commitments
- Clarification of fiduciary duties and stewardship rules of investors to reflect the financial sector's contribution to Green Deal targets
- Tools for supervisors to address greenwashing

Overview of Fit-for-55 package:

- Revision of the ETS (carbon pricing) to expand to more sectors, including aviation and maritime sectors
- Carbon Border Adjustment Mechanisms to address carbon leakage
- Revision of the Energy Tax Directive
- Revision of the regulation on the inclusion of greenhouse gas emission and removals from land use, land use change and forestry
- Amendment to the Renewable Energy Directive and Energy Efficiency Directive to implement the ambition of the new 2030 climate target
- ReFuelEU Aviation - sustainable aviation fuels
- FuelEU Maritime - green European maritime space
- Amendment of the alternative fuels infrastructure Directive
- Amendment of the Regulation setting in CO2-emission standards for cars and vans

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