Key sustainability trends that will drive decision-making in 2023

Lead authors: Lai Ly, Global Head of ESG Research, S&P Global Ratings | Lindsey Hall, Head of ESG Thought Leadership, S&P Global Sustainable1

Co-authors: Bruno Bastit, Terry Ellis, Paul Munday, Bruce Thomson, and Dennis Sugrue, S&P Global Ratings; Esther Whieldon and Jennifer Laidlaw, S&P Global Sustainable1

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HIGHLIGHTS

- In 2023, we believe sustainability initiatives could be tested by persistent inflation and economic uncertainty. Despite these headwinds, we continue to view that the sustainable debt market will help advance sustainability goals.
- As new sustainability disclosure standards come into effect around the globe, stakeholders will have to grapple with the complexity and potential challenges regarding alignment of these initiatives. The increasing risk of environmental, social and governance (ESG)-related litigation, including over sustainability disclosure, will be another challenge for companies and investors to navigate.
- Climate change and associated topics such as water scarcity and biodiversity loss are likely to dominate stakeholder discussions, with long-term climate goals potentially reevaluated to address near-term urgencies.
- The durability of sustainable employment practices, implemented in recent years in response to significant shifts in workforce expectations, will be challenged by recessionary risks in many markets. Meanwhile, new human rights regulations will introduce additional requirements for company supply chain management.

In 2023, we think continued geopolitical turmoil, persistent inflation, looming recession and worsening physical impacts of climate change will create new tensions between managing near-term risks and making meaningful progress on longer-term sustainability goals.

In the report that follows, we outline nine trends we see rising in prominence in the sustainability landscape during 2023. These trends are expected to impact a wide range of stakeholders, from companies, investors and workers to communities, regulators and policymakers. This list builds on many of the **trends we identified in 2022**, several of which we believe will remain relevant in 2023.

These trends highlight the delicate balancing act we see stakeholders facing and managing, weighing various and sometimes opposing forces. For example, long-term energy transition goals will be weighed alongside nearer-term considerations such as energy affordability and security. Progressive employment practices implemented in the wake of COVID-19 will be tested by cost-cutting related to economic uncertainty. This push-and-pull dynamic could be a hallmark of sustainability discussions and decisions throughout 2023.

This research is based on feedback from analysts and researchers across S&P Global.

Sustainability disclosure standards will pressure companies and investors to respond and adapt

In 2022, the European Financial Reporting Advisory Group (**EFRAG**), the U.S. Securities and Exchange Commission (SEC) and the newly formed International Sustainability Standards Board (**ISSB**) drafted various proposals for disclosure standards relating to sustainability and/or climate-related issues. The final drafts of these standards should be adopted in 2023. The EU Taxonomy came into force in 2020 but its first reporting provisions applied in 2022, and further disclosure requirements related to the Sustainable Finance Disclosure Regulation (**SFDR**) for financial market participants will become effective in 2023. The UK also intends to bring forward sustainability-related disclosure requirements at the entity and **product** level. More **countries** may make reporting under recommendations of the Task Force on Climate-Related Financial Disclosures (TCFD) mandatory, such as New Zealand, Singapore and Switzerland, where the requirement comes into force in 2023.

These new rules and disclosure standards aim to enhance transparency and consistency on sustainability-related issues and mitigate the risk of misrepresentation, perceived as greenwashing, in financial markets. However, they also face criticism because of their complexity and a continuing lack of global alignment. The proposals from the ISSB, EFRAG and SEC all use the TCFD framework as a reference for climate-related issues, but differences remain in their specific requirements and how

they treat wider sustainability issues. This has resulted in **calls for global convergence** to support consistency and avoid confusion and additional reporting workloads for companies and investors alike. Several initiatives, such as the Global Reporting Initiative and ISSB **collaboration** or **Net Zero Guidelines** from the International Organization for Standardization, may play a role in harmonizing the various standards. In 2023, we believe companies and investors will have to prepare for reporting under a number of new and complex sustainability disclosure standards and adapt as they continue to evolve.

Companies and investors will navigate the increasing risk of litigation related to sustainability (in)actions

In 2022, efforts to integrate ESG into corporate policies and investment decisions faced diverging pressures, either for lack of or inadequate action or for going too far. This has been reflected in more litigation, with an increasing number of **climate-related lawsuits** against corporates. While most cases have been against companies and investors for not doing enough on climate issues, we have seen an increase in lawsuits pushing back against ESG-related work or investment policies. For example, integrating ESG standards faces some opposition in the U.S., while in Europe and Asia, there are calls for greater action through regulations and public commitments. Litigation risk has also given rise to a new trend named by some as "greenhushing", whereby companies may refrain from disclosing details of their sustainability goals and practices for fear of being penalized for the information released.

Against this backdrop, we anticipate that 2023 will test companies and investors on the strength and depth of their sustainability commitments and the priorities they support in light of a growing risk of ESG-related litigation. We anticipate that some investors will increasingly check to see if companies are backing their words with actions, particularly on climate. Therefore, companies may face more scrutiny on appropriate board oversight and the maturity of their sustainability strategies and processes. For the same reasons, we expect that company and investor lobbying activities will come under greater scrutiny to ensure that they are consistent with public commitments to both sustainability and fiduciary mandates.

Climate strategies will be reconsidered in the face of energy security and affordability concerns

The global energy landscape shifted in 2022 with record prices and supply disruptions related to the Russia-Ukraine war. Some nations loosened restrictions on operating coal-fired power plants, while others extended the lives of coal and nuclear power plants. It appears increasingly challenging to meet the Paris Agreement goal to limit warming to 1.5 degrees to 2 degrees Celsius relative to preindustrial levels, as emissions should reach all-time highs in 2023.

In 2023, we think countries and companies will **consider balancing** energy security, affordability and the energy transition in a context of high inflation and rising interest rates. The picture looks **especially complicated in Europe**, where new investment in liquefied natural gas and a slower phaseout of coal could challenge decarbonization plans. Corporates investing in their own energy generation may find projects cost more in the short term. But while the costs of deploying solar have increased, these should start declining and have been relatively small compared to European natural gas price increases, which have risen nearly eight times higher over the past two years. Meanwhile, institutional investors under pressure to deploy capital are turning to still-developing voluntary carbon offset markets to meet climate commitments while continuing to finance assets and companies linked to fossil fuels.

Some governments have responded with new packages such as the **U.S. Inflation Reduction Act** and Europe's **REPower EU** to incentivize clean energy adoption and energy efficiency. This could help maintain investment momentum **in key technologies** and ultimately **deliver a faster energy transition** with increased energy security for countries and companies alike. Otherwise, if emissions continue to rise, meeting Paris Agreement goals could entail greater and more costly decarbonization efforts.

The rising costs from physical climate risks will accelerate investments in adaptation and resilience

All stakeholders will bear the impacts from physical risks related to climate change. Although the number of climate-related deaths has decreased threefold in the last 50 years thanks to early warning systems and better disaster management and preparedness, climate-related disasters are now **nearly five times as frequent**, according to the World Meteorological Organization. If the current trend continues, the number of disasters could rise to **560 per year by 2030**, up 40% from 2015. Lagging investments in the technologies and interventions needed to support adaptation are widening each year - up to **$340 billion per year** of adaptation finance is needed by 2030. The impacts from climate change will not be evenly distributed, with lower- and lower-middle income countries **more at risk** than higher-income peers and less ready to cope. An agreement reached at the U.N. climate change conference, known as COP27, for a "loss and damage" fund will seek to address adaptation and resilience challenges of developing countries.

With this in mind, **we think that adaptation will become as material as climate transition** in terms of protecting lives, assets and the productive capacity of the economy over time. We expect that 2023 will see significant attention paid to **adaptation and resilience financing**. In addition to more grants, concessional loans and equity, we foresee growing interest in innovative financing instruments, including debt-for-climate swaps, where debtor countries divert payments into adaptation and resilience projects and dedicated adaptation and resilience bonds. That said, we believe developing countries can only sustain so much debt to finance rising losses and lost revenues from physical climate risks.

Employment practices adapting to new workforce dynamics will be tested in the face of economic and labor-market uncertainty

As a result of COVID-19 and the intense competition for talent amid a period of exceptionally high employee turnover, **employee expectations** around health, well-being, culture, flexibility and benefits have **evolved** over the past two years. Consequently, many companies introduced new incentive structures, benefits, workplace culture initiatives (flexible work, DEI strategies and efforts to improve work-life balance) and career development opportunities to promote the employee experience and better attract and retain talent. We believe that dynamic could change as companies adjust in the face of economic uncertainty and changing labor market dynamics.

Promoting a strong employee experience can contribute to sustained competitiveness over the long term. Workers increasingly demonstrate willingness to adjust the time and effort they dedicate to their job or leave their positions for new opportunities if workplace culture does not align with their values and expectations. In 2022, **McKinsey & Co.** found that while total compensation remained important, other factors, including workplace flexibility and meaningfulness of work, have become more instrumental in many workers' decisions to stay at or leave a job.

But in the near term, if **economic conditions** continue to deteriorate and labor market resilience wanes, companies may face calls from investors to scale back more progressive workplace practices. Consequently, in 2023, we anticipate the durability of new employee-friendly workplace practices will be tested.

More resources will be devoted to managing human rights impacts in supply chains amid new sustainability regulations

Though geopolitical conflicts, inflation and the effects of climate change continue to pose risks to supply chain operations, there are indications that the supply chain disruptions of recent years **may be easing**. Nevertheless, we think companies will be pressed in 2023 to invest more resources into managing the resilience and sustainability of their supply chains in the face of a more rigorous regulatory landscape governing corporate responsibility around the impact on human rights.

One such law, the **German Supply Chain Due Diligence Act**, goes into effect in January 2023 and requires covered companies to conduct human rights and environmental due diligence to identify risks, remedy issues and establish grievance mechanisms, among other things. In 2022, the U.S. stepped up the enforcement of laws aimed at restricting imports of goods believed to be made in whole or in part with forced labor. The U.S. Customs and Border Patrol is enforcing 55 active Withhold Release Orders and targeted over 3,500 inbound shipments from 2021 to 2022. And the EU looks to advance its own human rights **due diligence directive** and **regulation** restricting goods made with forced labor throughout 2023.

Regulatory trends point to a hardening of what were largely voluntary frameworks for how companies manage human rights in their upstream operations. As a result, we think more companies, particularly those in industries with the greatest exposure

to **working conditions risks**, will face greater costs associated with building the systems and capacities needed to comply with new requirements. In addition to more substantial legal, operational, reputational and financial consequences of violations, companies may need to consider costs associated with adapting their sourcing models and managing higher input and production prices.

Climate change will continue to drive drought and water scarcity, sharpening the focus on water-related risks

Climate change is driving water scarcity and more severe and frequent droughts, hampering agricultural production, food supplies and economies. Since 2019, the number of people affected by food shortages has more than doubled to 345 million, roughly 4% of the world population, from 135 million, as reported by the **World Food Programme**. Meanwhile, the number and duration of droughts globally have risen by almost a third since 2000, according to the U.N. **Recent research** reinforces the link between increasing drought frequency and severity and climate change, which has made Northern Hemisphere droughts in summer 2022 at least 20 times more likely. Droughts impact major economies, including Europe, the U.S. and China, raising prices and creating potential food shortages that disproportionately impact the world's most vulnerable communities.

In 2023, we believe more investors and companies will seek to assess the social and financial costs associated with water scarcity and droughts. Some sectors, including utilities, oil and gas, and agribusiness, are more exposed to water stress than others and will face greater operating and financial challenges. **Agribusinesses** are particularly sensitive to water scarcity, leading to more expensive irrigation, crop damage and weak harvests, which may raise food security and supply concerns, already exacerbated by the Russia-Ukraine war. We also think attention will shift to water ahead of the inaugural U.N. Water Conference in March 2023, where governments and other stakeholders will review the objectives of the International Decade for Action on Water for Sustainable Development, 2018-2028.

Understanding of biodiversity and nature-related risks will reach an inflection point as more data and frameworks become available

COP27 in November 2022 was quickly followed by the U.N.'s Convention on Biological Diversity, known as COP15. These two events helped spotlight the links between two global environmental crises, climate change and biodiversity loss. Economies and nature are interconnected. Valuable flows of goods (such as food and commodities) and ecosystem services (such as the climate regulation that occurs when oceans and forests store carbon) support economic growth and human wellbeing. Despite this, biodiversity, essential to sustaining natural capital and ecosystem services, **is declining**. **Studies** project further losses in biodiversity by midcentury due to changes in both land use and climate, absent transformative changes to economies.

Following recent momentum, including that gathered during COP15, we believe policymakers, regulators, companies and investors will more explicitly look to factor biodiversity-related risks and opportunities into decision-making in 2023. The **provisional agreement** in the EU for new regulation for deforestation-free supply chain will mean many companies will have to better understand biodiversity risk. The Taskforce on Nature-related Financial Disclosures (**TNFD**), which should finalize its recommendations in September 2023, will provide frameworks to identify, measure and disclose nature-related risks and impacts. During COP15, the International Sustainability Standards Board (ISSB) announced that it will research the link between climate and nature. We also note that some regulators and central banks have already made the case as to why and how financial institutions should respond to rising risks and biodiversity losses. We believe that these initiatives, among others, will serve as catalysts for greater reflection by stakeholders about the impact, risks and opportunities associated with nature and biodiversity.

The global sustainable bond market will return to growth but contend with credibility challenges and market uncertainty

The global green, social, sustainability and sustainability-linked bond (GSSSB) market in 2022 **did not reach the highs set in 2021**, as rising interest rates and the risk of recession in many parts of the world sidelined debt issuers. In 2023, we think broader market conditions will continue to influence GSSSB issuance. We forecast that total global bond issuance will increase modestly in 2023[1] as rate rises subside, but inflation risks remain, and global growth is set to stagnate or even tip into recession in some regions. These macroeconomic and market conditions could constrain issuer appetite for GSSSB offerings. However, we still anticipate GSSSB issuance to grow to between $900 billion and $1 trillion in 2023 compared to nearly $850 billion in 2022 as the asset class capitalizes on various initiatives to fill the climate financing gap.

GSSSBs will also face ongoing questions about the effectiveness of sustainable debt in helping companies reach their sustainability goals, particularly in the relatively new and growing sustainability-linked bond segment. Sustainability-linked bond issuance fell sharply over the second half of 2022 as investors raised concerns about issuer ambitions and incentives to achieve sustainability targets. These instruments will have to increasingly address investor questions about the effectiveness of targets and incentives. The **call at COP27 for multilateral development banks** to scale up the use of blended finance to attract more private capital, and the push to boost adaptation finance, will underscore how GSSSBs can contribute to closing the climate finance gap. However, the continued lack of a global climate finance taxonomy remains a challenge to bringing transparency and comparability to the space.

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[1] "Global Financing Conditions: Bond Issuance Set To Remain Weak Through Year-End, Expand Modestly In 2023," S&P Global Ratings, Oct. 26, 2022.