MOODY'S | ESG Solutions

ESG Themes for 2022

2 FEBRUARY 2022

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ABOUT

Moody's is committed to helping market participants advance strategic resilience, responsible capitalism, and the greening of the economy. Our offerings span across credit, ESG, sustainable finance, and climate risk solutions and help our customers identify risks and opportunities and provide meaningful performance measurements and insights.

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ESG Measures – Global

ESG Themes for 2022

Summary

Having accelerated in the wake of the pandemic, access and affordability concerns will remain top of mind as rising inflation impacts living costs. We expect growing focus on how companies are addressing access and affordability of products and services, alongside improving sustainability performance.

Poor management of social and environmental risks in supply chains will compound ongoing operational resilience concerns that have proliferated over the course of the pandemic. Our ESG Assessment data finds "limited" disclosure scores on the integration of social and environmental factors in supply chains across key sectors.

Human capital management shifts will continue to put employees and their wellbeing into sharper focus. Working conditions and wider human resource practices are growing in importance, alongside elevated diversity, equity and inclusion concerns.

Turning momentum from COP26 into action will see demand for net zero accountability and transparency grow. Based on our Temperature Alignment dataset, only 3% of assessed companies globally are aligned with a future of net zero by 2050 based on their emissions reductions targets.

The "just transition" will become a stronger component of net zero economy plans and policies. Potential risks related to negative social consequences of the industrial transformations required will become more apparent for the most impacted sectors.

Last year's momentum on nature and biodiversity will continue. The launch of the Taskforce on Nature-related Financial Disclosures (TNFD) and growing requirements, such as Article 29 in France and others from the EU, demonstrate an acceleration in calls for meaningful biodiversity disclosure.

Mainstreaming of impact measurement and management will continue. Greater awareness of the responsibilities to invest in the infrastructure needed to take on systemic risks of the future will see the common language of the SDGs sought out by more parties.

ESG disclosure will take a step forward this year. But differences in the concept of materiality and the classification of sustainability activities will complicate efforts to create global standards.

Moody's ESG Solutions

Committed to forging a sustainable future, Moody's ESG Solutions can help your organization to better understand ESG performance, assess climate and environmental risk exposure, strengthen sustainability action plans and meet disclosure requirements. The unrivalled breadth and depth of our solution suite makes us uniquely placed to fulfil even the broadest spectrum of ESG-related goals in risk management, equity and credit markets.

Our craft begins with superior-quality data and analytical rigor: by combining over 30 years in ESG expertise with our best-in-class risk analysis, our expert team delivers fully customizable and flexible solutions to companies, banks, insurers, governments, as well as asset managers and asset owners that meet individual needs on a global scale.

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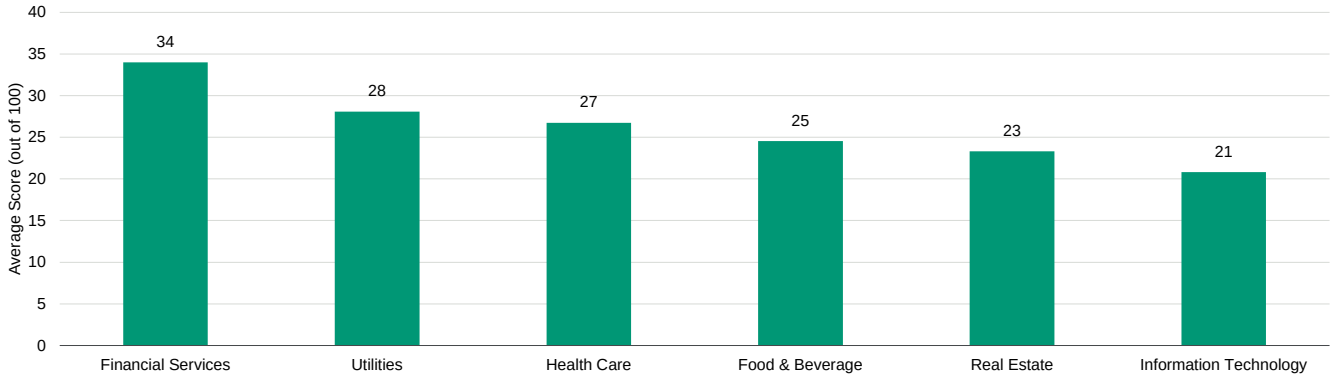
Increasing demand for greater affordability and better access to more sustainable choices

Having accelerated in the wake of the pandemic, access and affordability concerns will remain top of mind as rising inflation impacts living costs as weaker economic output has hampered growth of disposable incomes. Globally, all income groups have experienced a decline in average per capita income between 2019 and 2021. For people in the top 40% of global income distribution, average per capita income is down 2.8% on pre-pandemic projections. For the those in the bottom 40% of global income distribution, average per capita income is 6.7% lower.[1] We expect growing focus from investors on how companies are addressing access and affordability of products and services, alongside improving sustainability performance. Greater market demand for accessible goods and services that are sustainable can spur innovation and bring down cost curves, improving access and affordability and creating positive impact at scale. For example, for the food and beverage sector, improving affordability and a greater choice of healthier products can build new markets and make a positive contribution to health outcomes for a wider group of society.

Furthermore, through sustainability-focused product and service design improvements, companies can harness consumer behaviour to address social and environmental challenges linked to responsible consumption and production. Legislators, too, are beginning to strengthen action across a variety of areas, for example, in health, air quality, waste and greenwashing. These institutional shifts have the potential to support companies with the enabling environments needed for more sustainable products and services to be brought to market.

Addressing financial inclusion, affordability of utilities costs, providing healthcare, nutrition and housing that is accessible and tackling digital divides are some of the areas that investors can examine to assess corporate action in this field. At present, our ESG Assessment data finds largely "weak" (less than 30 out of 100 in our scoring) or "limited" (between 30 and 49 out of 100) performance addressing approaches to access to products and services for sectors that can support these activities (see Fig. 1).

Figure 1 Access to products and services by sector



Source: Moody's ESG Solutions

[1] See Poverty median incomes and inequality, a diverging recovery, World Bank, September 2021.

Supply chain: social and environmental issues to become an enduring part of the resilience planning

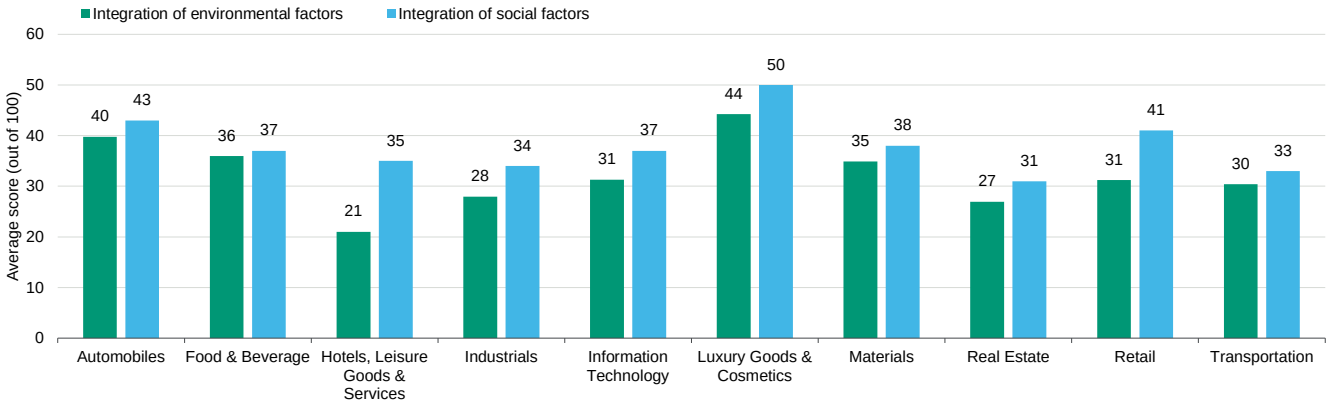
As supply chain resilience remains a concern, demand for better understanding of often complex and opaque sourcing, manufacturing and logistics arrangements will grow. While near-term logistics bottlenecks may ease for some sectors, poor management of social and environmental risks in supply chains will compound ongoing operational resilience issues that have proliferated over the course of the pandemic. Our recent research into supply chain controversies found that over 2020 and 2021 supply chain controversies had increased by 237% to an annual average of 185, up from an average of 78 cases per year between 2016 and 2019 before the onset of the pandemic.

Post COP26, with improved pledges on methane reduction and private sector net-zero targets, scope 3 emissions disclosures – which includes emissions from the supply chain - will become a stronger consideration for stakeholders. On social issues, the pandemic has sharpened reputational consequences of human rights impacts and workplace risks linked to fair wages and working conditions.

Regulators are increasing their focus on ESG risks in supply chains. The EU's Sustainable Corporate Governance legislative proposal, which may include mandatory human rights due diligence, will arrive this year. Meanwhile many EU countries are creating their own national laws, for example, France, Germany and the Netherlands, adding to growing legislation, for example in the US and the UK. Market practitioners will not wait for robust disclosure across the board, however, meaning that the role of new technologies and analytical techniques will be important in helping to bridge the disclosure gap across supply chains.

Our ESG Assessment data finds largely "limited" performance on integration of environmental and social factors in supply chains across key sectors, with a stronger integration of social over environmental issues (See Fig. 2). Furthermore, out of selected companies assessed, we find that dedicated social and environmental audits are only carried out by 23% and 17% of companies respectively.

Figure 2 Integration of environmental and social factors into supply chains



Source: Moody's ESG Solutions

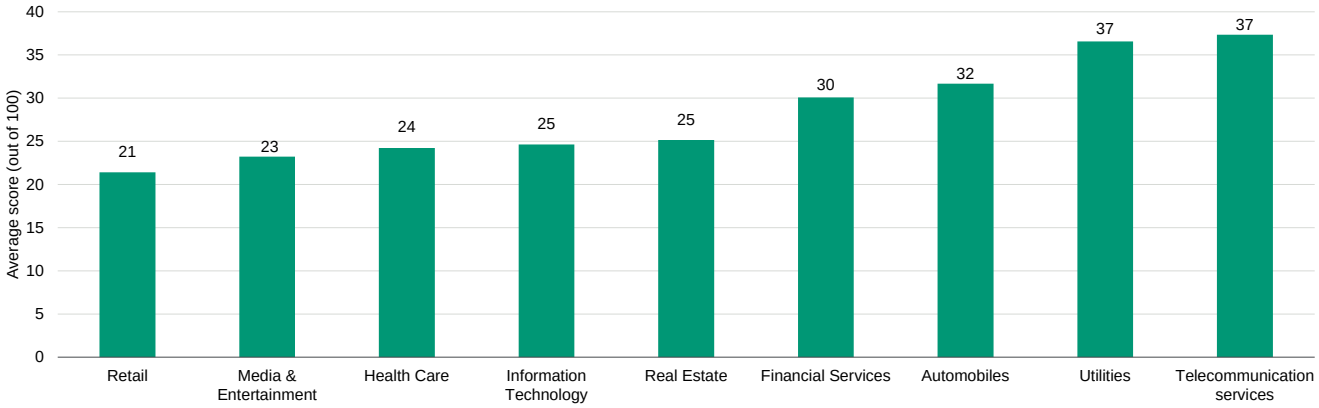
Workers and wellbeing: glimpses of a new future of work?

As unemployment rates in some countries return to pre-pandemic lows, poor human capital management practices and related poor-quality disclosures are a growing area of risk for companies. For many workers prior to the pandemic, the rise of automation and growth of platform-based working was having a profound impact on the nature of work, for example, through changing working patterns and altering employer-employee relationships.

Though the pandemic is accelerating this trend, tight labour markets for certain lower wage sectors in high income countries are increasing attention on a wide range of human capital management performance issues. Pay is not the only area that is in now focus. Working conditions and labor rights are coming under growing scrutiny, not just from employees and legislators but also from investors. These workplace issues add to a growing focus on diversity, equity and inclusion (DE&I) that has continued to strengthen over the course of the pandemic.

Our ESG Assessment data of key sectors finds that retail performs poorest for human resources, which encompasses a range of human capital management issues, with all sectors achieving "weak" or "limited" overall results for this criteria (see Fig. 3).

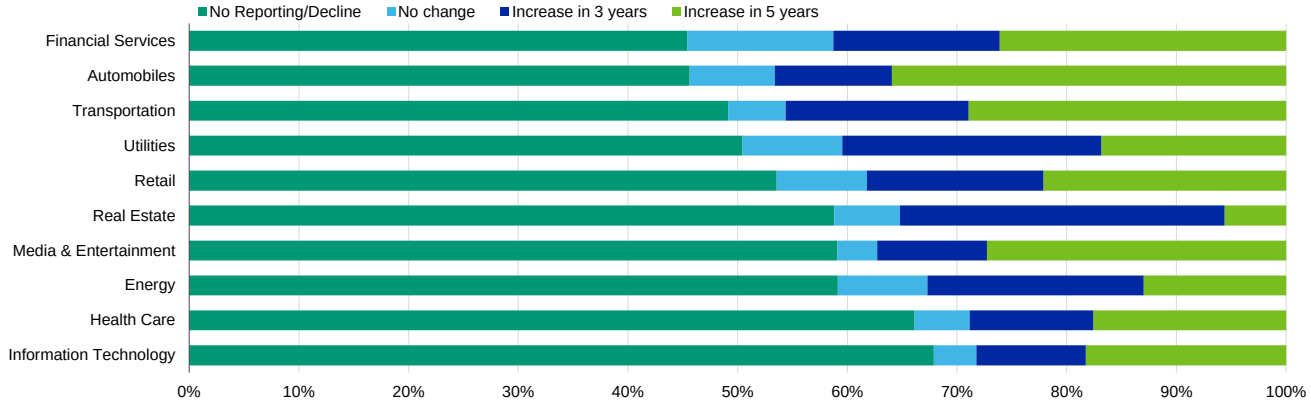
Figure 3 Human resources performance by sector



Source: Moody's ESG Solutions

DE&I scrutiny will remain elevated. Disclosures on percentage change of women in management positions finds little recent improvement across sectors, with information technology and health care sectors performing poorest with an average of just 14% of firms in those sectors increasing their share of women in management positions in the last 3-5 years (see Fig. 4).

Figure 4 Change of women in management positions by sector (%)



Source: Moody's ESG Solutions

Net Zero: A need for innovation, ambition, and accountability in 2022

The past seven years were the seven warmest on record, with devastating impacts globally ranging from record-setting wildfires and heat waves to deadly floods and hurricanes. In the near-term we will continue to experience extreme climate-driven events due to carbon already in the atmosphere, which calls for urgent investment in climate adaptation. However, in the longer term there is an opportunity to avoid the worst impacts of physical risks by transitioning to net zero by 2050 which is required to limit global warming to 1.5°C by 2100, according to the IPCC.

The first part of the Intergovernmental Panel on Climate Change's (IPCC) sixth assessment report released last August called for a "rapid and far-reaching" transition to net zero emissions in land, energy, industry, buildings, transport and cities by 2050. The IPCC is scheduled to release the rest of their sixth assessment reports in February and March 2022, focused on impacts, adaptation and vulnerability, and on mitigation respectively, which will provide important insights for adapting to climate change, as well as mitigation and reaching net zero.

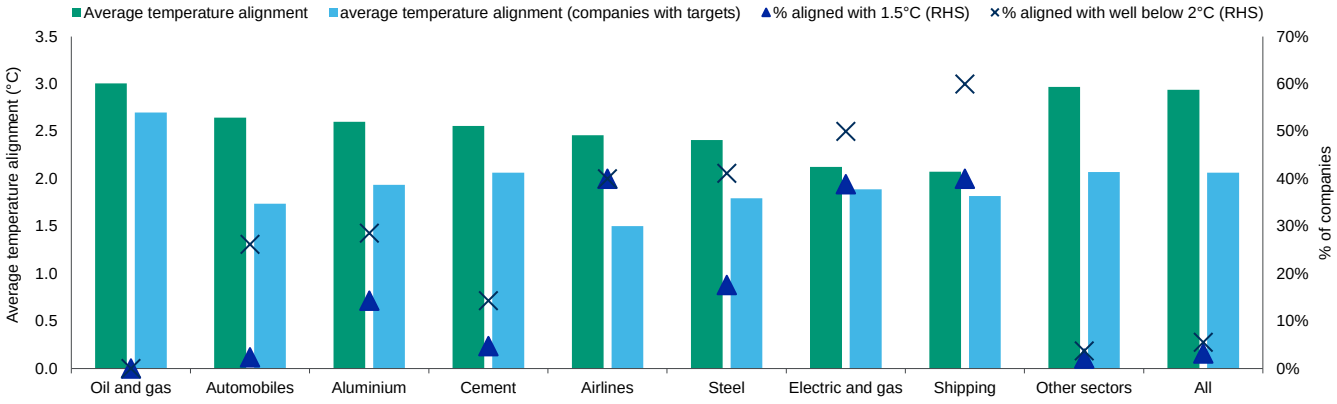
Following August's report a surge in net zero commitments emerged alongside COP26. As of the end of 2021 country net zero targets between 2050 and 2070 cover nearly 90% of global emissions, including the four largest emitters – China, the US, EU and India.

A key development at COP26 was the increase in financial sector commitments to address climate change as a systemic financial risk. The United Nations Glasgow Financial Alliance for Net Zero (GFANZ), a group of investors, banks and insurers controlling $130 trillion in assets, pledged that their investments will hit net zero emissions targets by 2050.[2] While such commitments signal significant progress, there are key challenges ahead in terms of the need for accountability, understanding the relationship between portfolio financed emissions and emissions reductions in the real economy, and the need for innovation to finance a rapid and just transition to net zero.

With the growing number of net zero commitments by governments, companies and financial institutions comes a growing need for transparency on what these commitments mean in practice and what interim steps will be taken to achieve net zero. Investors, and banks in particular, must understand corporate net zero plans to translate that into the implications for their own portfolios. There will be a continued growth in forward-looking metrics to assess companies' pathways to net zero, driven by this demand.

Research based on Moody's ESG Solutions Temperature Alignment Dataset, covering roughly 4,400 large companies, finds that 42% of assessed companies have set emissions targets in some form, but only 17% refer to "net zero".[3] Globally, only 3% of our assessed companies are aligned with a future of net zero by 2050 based on their emissions reductions targets and the average temperature rise across the assessment universe is 2.9°C. This demonstrates the need for increased corporate ambition alongside continued efforts to unpack the implications of existing corporate commitments.

Figure 5 Average temperature alignment, % alignment by sector



Sources: Company reports, International Energy Agency, Moody's ESG Solutions

Just transition and equitable adaptation

The push towards a net zero global economy demands an unprecedented industrial transformation. Over time, new industries will emerge, creating new jobs and contributing to building a safer and healthier planet. In the near term, disruption will exacerbate existing societal challenges and dislocate the most exposed workforces, supply chains, communities and consumers – particularly those already facing disproportionate challenges due to income, race and other factors. The COP26 Just Transition Declaration signals a global effort to harmonize expectations of a just transition to net zero with more than 30 countries as signatories. In finance, investor action is growing. Coalitions have also formed around just transition activities, including the Paris-based Investors for a Just Transition, representing €4.3 billion of assets under management and the multistakeholder Financing the Just Transition Alliance, coordinated by the Grantham Research Institute on Climate Change.[4] Just transition assessments are also beginning to emerge as companies begin to face greater scrutiny in 2022 from investors, policymakers and consumers on their management of

[2] Moody's Corporation is a founding member of the Net Zero Financial Services Provider Alliance, part of the Glasgow Financial Alliance for Net Zero (GFANZ). See Moody's Announces Participation in New GFANZ Alliance: Commits to Align Products and Services to Achieve Net-Zero Greenhouse Gas Emissions by 2050, September 2021.

[3] This coverage is based on an analysis in December 2021, and the coverage universe has since expanded.

[4] Moody's ESG Solutions is a founding member of Finance for Tomorrow and exclusive data partner for the Investors for A Just Transition platform. The data hub with access to company scores across a range of relevant indicators can be accessed on their website.

the social consequences of the transition to net zero. Corporate and industry reorganisation in response to increasing transition and physical climate risks will see certain jobs disappear, communities negatively impacted and new skills required to support emerging industries. Stakeholders will expect better understanding of how companies are supporting workers through reorganization and reskilling and how they are supporting affected communities. Our initial global analysis of selected sectors that are both carbon- and labour-intensive finds that average company performance across seven criteria is "weak" or "limited," demonstrating the substantial room for improvement (See Fig. 6).

Figure 6 Average global scores by sectors across just transition-relevant indicators

	RESPONSIBLE MANAGEMENT OF REORGANISATION	CAREER MANAGEMENT AND PROMOTION OF EMPLOYABILITY	PROMOTION OF LABOUR RELATIONS	PROMOTION OF SOCIAL AND ECONOMIC DEVELOPMENT	NON-DISCRIMINATION	RESPECT FOR HUMAN RIGHTS STANDARDS AND PREVENTION OF VIOLATIONS	MINIMISING ENVIRONMENTAL IMPACT FROM ENERGY USE
Automobiles	17	32	29	29	44	37	39
Building Materials	17	31	27	41	41	40	44
Electric & Gas Utilities	24	37	36	46	50	43	28
Energy	20	31	24	44	45	39	30
Food	14	29	22	35	42	39	38
Forest Products & Paper	27	40	45	47	50	46	49
Heavy Construction	19	31	31	35	42	43	40
Industrial Goods & Services	16	31	25	30	46	41	36
Oil Equipment & Services	15	26	16	39	40	34	28
Transport & Logistics	18	31	29	28	43	39	44
Travel & Tourism	16	31	28	28	46	44	45
Median Indicator Score	17	31	28	35	44	40	39

Note: Our scoring of sectors across relevant just transition criteria finds average performance to be weak (lower than 30 out of 100 denoted in red) or limited (from 30-49 out of 100 denoted in orange), with few robust scores (from 49 to 59 out of 100 denoted in yellow) and particular challenges for workforce and labour issues. Dataset includes relevant companies across all regions globally.

Source: Moody's ESG Solutions

Transitioning the workforce in a just and equitable manner also requires a consideration of workers' exposures to physical risk. Based on our analysis of physical climate risk for about 5,000 publicly listed companies and their roughly 2 million underlying corporate facilities, nearly all analyzed sectors have over 30% of their assessed facilities exposed to both heat stress and water stress. Occurrence of extreme events will only increase in the near-term and these hazards will carry implications for public health with rippling impacts on labour productivity and business costs.

Mainstreaming biodiversity disclosure and nature aligned business model change

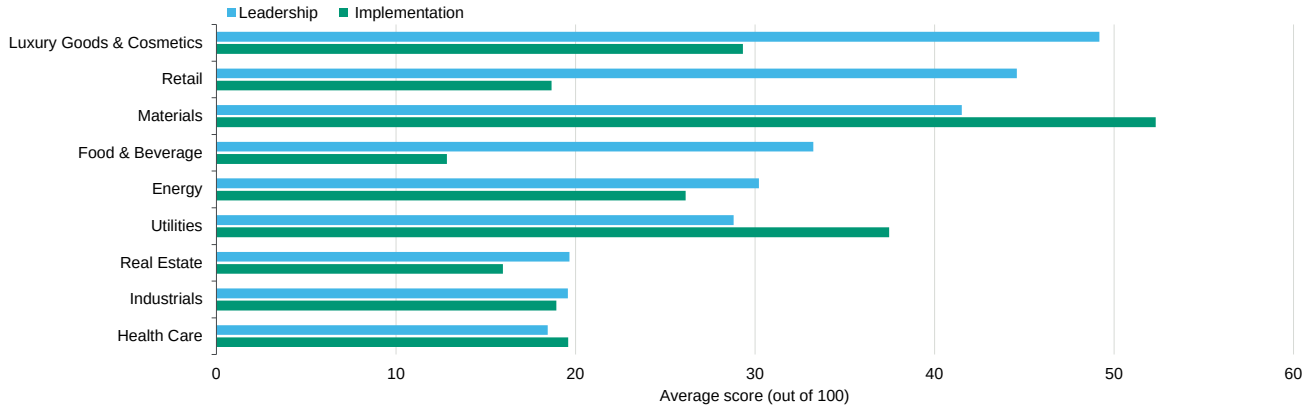
Last year's momentum on nature and biodiversity will continue. Strong signals suggested that the recognition of role of finance in supporting biodiversity was moving to the mainstream. The Dasgupta Review highlighted that financial decisions have not taken nature into account and economic sustainability requires a new approach to accounting for nature. The World Bank set out the economic case for nature, stating that the global decline in biodiversity and ecosystem services could result in a decline of 2.3% global GDP ($2.7 trillion) annually by 2030.

At COP 26, significant pledges on forests and natural capital firmed up the link between taking action on biodiversity and tackling climate change. The launch of the TNFD; developing disclosure requirements, such as the updated Article 29 in France and those within the EU SFDR; forthcoming EU Taxonomy technical screening criteria and the recently launched World Benchmarking Alliance nature and biodiversity benchmark draft; and the proposed creation of investor coalition Nature Action 100 will all add to the momentum.. Should it follow the development and adoption path of TCFD, TNFD will see biodiversity reporting demands and requirements coming faster than many companies may be expecting. This year's COP 15 on biological diversity, where the Post-2020 Global Biodiversity Framework will be adopted, will intensify the focus of stakeholders on a lack corporate action and the need to address the biodiversity financing gap - estimated to be approximately $711 billion per year to 2030.

Disclosures on both leadership commitments to biodiversity and on management of impacts and dependencies on nature are both essential governance building blocks to understand exposure to nature related risks and impacts. On these subjects in our methodology we define the leadership of the company as the exhaustiveness of relevant commitments to addressing biodiversity.

To address governance and management of impacts and dependencies, we asses the implementation of measures to address biodiversity risks, including an assessment of the processes in place at management level and at site level, their coverage and the geographic scope of implementation. Our ESG Assessment data on current biodiversity performance finds a gap between leadership commitments and implementation for key sectors with substantial biodiversity impacts and dependencies, such as food and beverage and luxury goods and cosmetics (see Fig. 7).[5]

Figure 7 Biodiversity leadership commitments vs implementation performance by sector



Source: Moody's ESG Solutions

Impact and SDGs

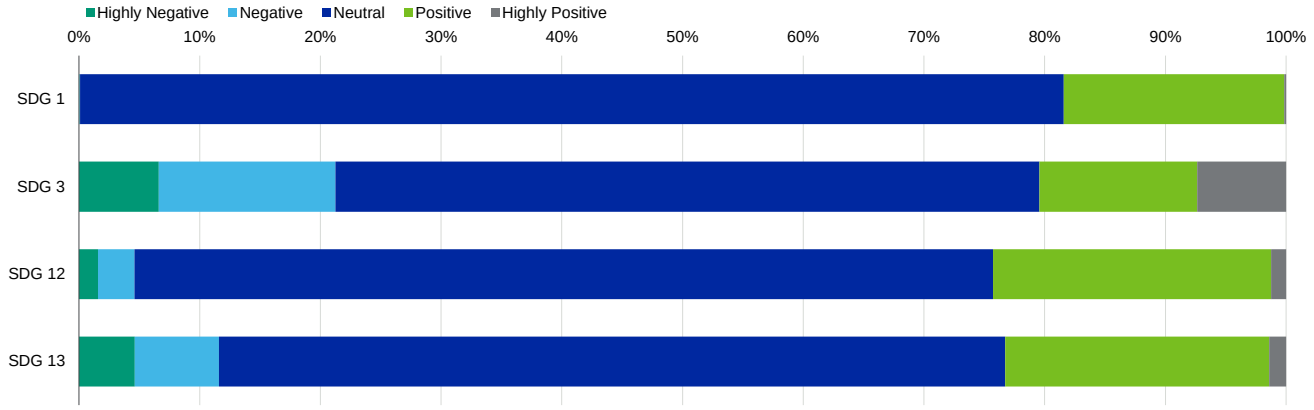
Mainstreaming of impact measurement and management will continue, driven forward by a growing need to address the negative impacts of the pandemic with intentional action that drives capital and enterprise towards proactively addressing the world's biggest challenges. As set out in the G7 Impact Taskforce Recommendations last year, positive impact that is intentional and additional should be easier for investors to back and have stronger codification in standards and regulation. Better integration of assessed and verified positive contribution across companies and investors will allow capital to flow to new industries geared towards positive impact. These efforts can complement new institutional measurement approaches that are emerging to quantify national progress that takes social and environmental crisis into account, for example the Planetary pressures-adjusted Human Development Index.

One source of momentum will be the introduction of double materiality into European disclosure and supervisory regimes, placing stakeholders and impact on an equal footing with financial risk. Another will be growing interest for more sophisticated tools for measuring impact aligned to the UN Sustainable Development Goals (SDGs). Greater awareness of the responsibilities to invest in the infrastructure needed to take on systemic risks of the future will see the common language framework of the SDGs sought out by more parties. Furthermore, strengthening of outcomes and impact disclosures will improve transparency and reduce green and social washing.

Our SDGs Alignment Screening tool measures corporate net contribution and net behaviour on each of the 17 SDGs. An assessment of corporate net contribution across a selection of core Goals representing social, economic and environmental activities (SDG1, SDG3, SDG 12 and SDG13) finds low "positive" results, with most companies' positive contribution performing weaker than that of their behaviour. This highlights a performance gap between more straightforward alignment to the SDGs and the more challenging step of taking intentional action that has the potential to create positive impact.

[5] For more on our approach to biodiversity risk assessment see Integrating biodiversity into a risk assessment framework, Moody's 2021

Figure 8 Corporate net contribution to SDG 1, SDG3, SDG 12, SDG 13 (%)



Source: Moody's ESG Solutions

Future of ESG data quality, gaps, and availability

The harmonization of ESG disclosure will take a step forward this year, but differences in the concept of materiality and the classification of sustainability activities will complicate efforts to create global standards. Building on two and a half decades of voluntary disclosure framework experience, progress this year on standards from the International Sustainability Standards Board and the European Commission will begin to set out a standardised and widely adopted base layer of consistent, comparable and reliable disclosure. Globally, ESG regulatory requirements will continue to grow at pace with revisions tightening existing provisions. National and regional taxonomies will become more widespread, raising future questions of interoperability and compatibility. Consistent, comparable, complete and reliable disclosures will provide a foundation of decision-useful ESG information to capital markets.

That the EU Sustainability Reporting Standards are set to be mandated through the Corporate Sustainability Reporting Directive (CSRD) is significant. The building out of the Standards, the Directive's widened scope to approximately 50,000 companies (from approximately 11,000) and its new requirement for limited assurance, will create a layer of valuable corporate data and move forward the ambition of establishing 'a comprehensive and mandatory sustainability reporting landscape' in the region. These disclosures will then flow up into the relevant existing components of the EU Sustainable Finance Strategy: the EU Taxonomy and the Sustainable Finance Disclosure Regulation (SFDR), where current data availability challenges are hindering effective disclosure. At present, our analysis finds a gap of approximately 36% between eligible and aligned EU Taxonomy activities for companies in major European countries, highlighting the need for support for more effective and complete disclosure.

Elsewhere this year other national taxonomies will continue to emerge and solidify. Last year the Future of Sustainable Data Alliance identified 25 separate national and regional taxonomy initiatives at various stages of development. As they move beyond climate objectives alone and encompass a wider set of economic activities, their value will become more tangible to a wider set of stakeholders. Questions around interoperability and compatibility of national taxonomies will grow in importance for investors and regulators. Common language that is science-based and provides the required level of detail will be important to scale taxonomy-backed green and sustainable finance activities globally.