SLAUGHTER AND MAY/

NATURE - THE NEXT ESG FRONTIER FOR CORPORATES?

Governance, Sustainability & Society – Part of the Horizon Scanning series

Looking beyond climate change

A company's relationship with the environment goes beyond its CO_2 emissions. While boards will understandably be focused on recent climate-related initiatives, organisations should also be thinking about their impacts and dependencies on the natural environment as a whole, and whether their relationship with nature is sustainable. This year, the publication of the Dasgupta Review, the launch of the Taskforce for Nature-related Financial Disclosures and the signing of the G7 2030 Nature Compact have shown that nature-related initiatives are attracting attention at the highest levels and have real momentum. In this note, we look at some of the latest nature-focused developments and consider what corporates can do to get ahead of the curve.

In recent years, corporate responsibility for climate change has attracted increased attention from legislators, regulators, investors and activists alike. Boards should already be well aware of the need to manage climate-related risks and of the opportunities presented by the transition to a 'net zero' economy, with real action needed now. In the UK, the government's Green Finance Strategy is introducing mandatory climate-related reporting throughout the economy by 2025, with the regime for premium listed commercial companies already in effect. Beyond mandatory reporting, a range of investor-led and sectoral initiatives are setting ever more stringent standards of best practice. Climate-related considerations will need to be embedded even deeper into corporate decision-making after the COP26 conference in November 2021, with new and amended legislation anticipated in several jurisdictions (which could include bans on new internal combustion engines, halting fossil fuel subsidies, and increased investment in innovative technologies such as carbon capture).

However, a company's relationship with the environment goes far beyond its CO_2 emissions and its exposure to climate-related risks and opportunities. While climate change is often described as the defining issue of this generation, the planet is also being harmed by mankind in other ways which are equally severe and in many cases irreversible. Examples include reductions in biodiversity, species loss, destruction of habitats and ecosystems, resource depletion, deforestation, loss of soil fertility, over-fishing and plastic pollution. Since 1998, the World Wide Fund for Nature has published biennial 'Living Planet Reports' documenting the impact of human activity on the environment; the most recent edition concludes that the planet's natural resources are being destroyed at a rate unprecedented in history, harmed by an explosion in global trade, consumption, urbanisation, and population growth.

While most corporates will be aware of these issues, nature-related considerations have – to date – attracted less scrutiny and demanded less concrete action than climate change. The reasons for this are complex, but principal among them is the lack of a standardized metric with which to evaluate performance (which can be contrasted with calculable and comparable CO_2 emissions across scopes 1, 2 and 3, and the 'net zero' target). Nonetheless, 2021 has seen some significant developments which suggest that companies' relationships with nature will be the next frontier of the ESG agenda once businesses have reconciled themselves to their Paris Agreement CO_2 targets.

What is 'natural capital'?

An additional dimension to the debate around mankind's relationship with nature is the concept of 'natural capital'. Natural capital is the idea that, beyond its intrinsic value, the natural world has significant and often overlooked economic value. Alongside produced capital (roads, buildings, machinery, etc.) and human capital (knowledge, skills, health, etc.), natural capital represents the value of the goods and services that nature provides for free (e.g. food, water, shelter, disease regulation, and oxygen production, among many others). Despite the significant economic value of natural capital, the economic performance of both countries and companies has conventionally been assessed without any regard to the use or value of natural capital. Goods and services provided by nature, and the consequences of our actions on the natural world, are usually regarded as "externalities" which appear off-balance sheet, and to which no economic value is ascribed. This in turn means that governments and businesses have little incentive to preserve natural capital or to use it responsibly.

While not all of the goods and services that nature provides are easily valued in financial terms, examples include the value of seafood caught from the ocean, the value of 'pest control' services provided by predators (i.e. the cost of using insecticide to protect crops in areas where wild bat habitats have been destroyed), and the value of natural pollination services (i.e. the cost of manually or mechanically pollinating crops in the absence of healthy bee populations). One estimate places the annual value of all goods and services provided by nature to be approximately $125 trillion, and another places the annual value of currently-recorded 'human' economic output which is actually moderately or highly dependent on nature at $44 trillion.

It is also clear that, through human intervention, the economic value of the planet's natural capital is decreasing at an alarming rate. The United Nations Environment Programme estimates that, per person, our global supply of natural capital has declined by nearly 40% since the early 1990s, while produced capital has doubled and human capital has increased by 13% over the same period. To give one example of the decline in natural capital, it is thought that the economic value of our oceans is reducing by approximately $50 billion every year due to over-exploitation.

The recognition and preservation of natural capital is also linked to the broader ESG agenda in a number of ways:

- While distinct from climate change, there is a very close relationship between nature and climate change. On the one hand, climate change is one of the principal ways in which humans are damaging the natural environment (e.g. climate change contributing to the degradation of coral reefs and the resulting damage to oceanic ecosystems), and so meeting Paris Agreement emissions targets will be critical to our ability to reverse biodiversity loss. On the other hand, nature-based solutions (e.g. the preservation and restoration of natural carbon sinks) must form a key part of humanity's response to climate change if we are to meet Paris Agreement targets.
- Natural capital comprises the majority of wealth in low income countries, and those in low income countries are typically more reliant on natural resources than those in high income countries. The conservation and restoration of natural assets will help to alleviate global poverty.
- The demands that humanity places on nature are correlated with the growing human population. Improving women's access to finance, information and education globally will not only help to manage the demands we place on nature, but will also help to further several of the United Nations' Sustainable Development Goals.

By recognising a capitalist basis for the protection of nature, the concept of natural capital has the potential to significantly expand the coalition of stakeholders who are interested in environmental conservation. However, the idea of attributing an economic value to nature is not without its detractors. Some NGOs have resisted engaging with the concept altogether, on the basis that nature's value is fundamental and intrinsic, and that the protection of nature should be seen as an end in itself (and not a means to an economic end). Further, by placing an economic valuation or a 'price' on nature, a framework is created in which the value of natural capital can be traded off against the value of produced capital or human capital.

The Dasgupta Review

In 2019, HM Treasury commissioned Professor Sir Partha Dasgupta (University of Cambridge) to explore the economic benefits of biodiversity and the economic costs of biodiversity loss. An interim report was published in April 2020, with the final 610 page report published in February 2021. The Dasgupta Review has been hailed as a landmark publication, in the vein of the Stern Review on the economics of climate change published in October 2006.

The findings of the Dasgupta Review are stark:

- That our reliance on nature is deeply unsustainable, with the demands we place on nature far exceeding nature's capacity to supply us with goods and services. The Global Footprint Network estimates that we would require 1.6 planet earths to maintain the world's current living standards, and that the date on which humanity will exhaust the sustainable natural capital 'budget' for 2021 is on 29 July 2021 (after which, humanity will be operating at an ecological 'deficit', depleting the natural resources available for use in future years).
- That the true economic value of natural capital is not reflected in market prices, because much of it is open to all and free-of-charge, and because nature is treated as an externality in conventional accounting systems. Further, damage to natural capital is often invisible, hard to trace and goes unaccounted for. These distortions mean that we overvalue, and overinvest in, non-natural assets (such as produced capital), but undervalue, and underinvest in, natural resources.
- That there has been a broad institutional failure to preserve natural resources. Almost everywhere, governments exacerbate the problem by paying businesses more to exploit nature than to protect it; Dasgupta estimates the global annual value of nature-damaging subsidies to be around $4-6 trillion. Further, the lack of international co-operation over natural assets allows individual nations and businesses to exploit shared global resources with minimal collective oversight.

While stressing that our current relationship with nature represents extreme risk and uncertainty for all economies, the Dasgupta Review concludes that it is not too late to change course. Restoring a sustainable relationship with nature "*will require transformative change, underpinned by levels of ambition, co-ordination and political will akin to, or even greater than, those of the Marshall Plan*". Dasgupta recommends a number of concrete actions to recalibrate humanity's relationship with nature, including:

- **Reduce individual consumption:** The simplest way to ensure that the demands we put on nature do not exceed its supply, is to reduce those demands. While technology and innovation will pay a part in this, we cannot rely on technology alone; consumption and production patterns must be fundamentally restructured.
- **Increase nature's supply relative to its current level:** Conserving and restoring natural assets is the easiest way to sustain and enhance their natural capital value. It is less expensive to conserve nature than to restore it once damaged or degraded (if indeed it can be restored at all).
- **Change our measures of economic success:** Common measures of economic activity, such as GDP and conventional financial reporting frameworks, do not account for the depreciation of natural assets and instead encourage the pursuit of unsustainable growth and development. Inclusive measures of wealth, which reflect the economic value of natural capital, should be adopted.
- **Create supra-national institutions to protect natural assets:** Given that ecosystems are shared global assets that transcend national boundaries, supra-national institutions should be created to control and protect the exploitation of critical natural resources that either fall within existing national boundaries (e.g. rainforests) or outside them (e.g. oceans).
- **Re-direct funding:** Promote a financial system that channels public and private investment towards activities that enhance natural assets

and encourage sustainable consumption and production.

- **Education:** While institutional intervention will help to protect nature, the influence of individuals will also be critical. Establishing the value of nature in educational policy is key to ensuring that individuals are empowered to make informed decisions and demand change from those involved in the production and supply of the goods and services that they consume.

The Taskforce on Nature-related Financial Disclosures

Notwithstanding the significant challenges associated with nature-related accounting and reporting (principally in relation to design, measurement and data collection), a number of initiatives are at different stages of development which aspire to reflect the value of natural assets in accounting standards, or provide frameworks for nature-related disclosure.

One of these initiatives is the Taskforce on Nature-related Financial Disclosures (TNFD), which launched in June 2021. It is inspired by, and is intended to build upon, the success of the Taskforce on Climate-related Financial Disclosures (TCFD), which has rapidly evolved from being a sector-led initiative launched in December 2015 to becoming the bedrock of the UK government's climate-related disclosure framework. The TNFD intends to create a framework for organisations to report and act on nature-related risks, supporting a shift in global financial flows from nature-negative outcomes to nature-positive outcomes. The disclosures will also enable asset managers to properly monitor the material risks posed by biodiversity loss and ecosystem collapse on their investments, as well as the opportunities presented by the transition to a nature-positive sustainable economy. One key difference between the TCFD and TNFD is that the proposed TNFD framework will require companies to report on *both* the impact of nature on their businesses *and* the impact of their businesses on nature (whereas the TCFD framework only requires one-way disclosure on the impact of climate change on the business itself).

Despite launching only a month ago, the TNFD already has a number of influential supporters from a wide variety of sectors, with endorsements and/or informal working group participation from Barclays, BP, GlaxoSmithKline, Lloyds Banking Group, M&G, NatWest Group, Reckitt Benckiser, Rio Tinto and Standard Chartered (to name some of those based in the UK). The TNFD is about to launch its "build" phase, during which the disclosure framework will be developed by a panel of approximately 30 members from industry, including both financial and non-financial corporates. The framework will then be tested across both developed and emerging markets, before being revised and consulted on. TNFD aims to launch and disseminate the final framework in 2023.

Once introduced, it is easy to envisage the TNFD framework following the same trajectory as the TCFD framework, albeit to a much shorter timetable – i.e. immediately becoming a best practice standard for nature-related disclosures, before swiftly being adopted by a broad range of stakeholders for different purposes (e.g. forming the basis of a mandatory reporting regime in the UK and/or being incorporated into ESG lending criteria).

G7 2030 Nature Compact

The preservation of nature was also one of the main topics of discussion at the G7 summit held in Cornwall in June 2021. Following those discussions, the G7 leaders adopted the G7 2030 Nature Compact, in which they welcomed the findings of the Dasgupta Review, recognised the 2020s as a "*critical decade*" for nature, and committed to:

- Halt and reverse biodiversity loss by 2030.
- Take bold action during 2021 for the delivery of ambitious outcomes for nature (including at the COP26 conference).
- Mobilise on a whole-of-Government basis to protect nature.

In order to meet these high level commitments (and, in particular, the commitment to halt and reverse biodiversity loss by 2030), the G7 2030 Nature Compact goes on to set out detailed pledges of the G7 leaders across four core 'pillars':

- **Transition:** The leaders committed to directly address unsustainable activities which negatively impact nature. This included (i) committing to tackle deforestation, including by supporting sustainable supply chains and demonstrating clear domestic action, (ii) acknowledging the harmful effect of some subsidies (in particular agricultural subsidies) on the environment and the need to reform policies with negative impacts on nature, and (iii) committing to address the adverse impact of human activity on the marine environment, including plastic pollution and unsustainable fishing practices.

- **Investment:** The leaders committed to dramatically increase investment in nature from all sources, and to ensure that nature is accounted for in economic and financial decision-making. This included (i) committing to increase public funding for nature-based solutions through to 2025, and (ii) ensuring that international development assistance does no harm to nature. The G7 leaders explicitly welcomed the creation of the TNFD to drive investment in natural capital and to embed the consideration of nature-related risk and opportunity in investment decisions.
- **Conservation:** The leaders committed to support and drive the protection, conservation and restoration of ecosystems critical to halt and reverse biodiversity loss and environmental degradation. This included (i) supporting new targets to conserve or protect at least 30% of global land and at least 30% of global ocean by 2030, (ii) supporting new targets to prevent the loss, fragmentation and degradation of ecosystems and to restore significant areas of degraded and converted ecosystems, (iii) committing to introduce targets to increase the abundance of species populations worldwide, significantly reduce overall species extinction risk, and eventually stop human-induced extinctions, and (iv) driving increased global co-operation on the ocean.
- **Accountability:** The leaders committed to hold themselves accountable for taking domestic and global action for nature, including in relation to the initiatives set out above.

Nature-related initiatives of the European Commission

The European Commission has also shown foresight by including nature alongside climate change in its most recent sustainability initiatives.

Taxonomy Regulation

Together with the Sustainable Finance Disclosure Regulation (SFDR), the Taxonomy Regulation serves as a key legislative pillar of the European Union's Action Plan on Sustainable Finance. The Taxonomy Regulation's role is to establish a unified classification system of environmentally sustainable economic activities. Our previous publications on the SFDR and the Taxonomy Regulation, and what they mean for asset managers and corporates across Europe and in the UK, are available here and here.

The Taxonomy Regulation identifies six fundamental objectives to which environmentally sustainable economic activities can be oriented: climate change mitigation; climate change adaptation; sustainable use and protection of water and marine resources; the transition to a 'circular' economy; pollution prevention and control; and the protection and restoration of biodiversity and ecosystems.

Legislation relating to the first two objectives – both of which relate to climate change – will apply from 1 January 2022, with secondary legislation having been adopted on 4 June 2021 which sets out the technical screening criteria for determining when an economic activity qualifies as contributing to one of those two climate-related objectives. While the Commission's initial priority was to implement the climate-related elements of the Taxonomy Regulation, the nature-related elements will follow only 12 months behind. Legislation relating to the remaining four objectives – all of which relate to nature and the preservation of natural capital – will apply from 1 January 2023, and the supporting secondary legislation must be published and adopted by the Commission by the end of this year.

Corporate Sustainability Reporting Directive

On 21 April 2021, the Commission adopted a proposal for a Corporate Sustainability Reporting Directive (CSRD), which would amend the existing non-financial reporting requirements under the Non-Financial Reporting Directive (NFRD). The proposed changes to sustainability reporting are profound, and would require entities to report on (among other things) environmental factors in far greater detail than under the NFRD. The CSRD proposals place equal focus on climate-related reporting and nature-related reporting, with in-scope companies needing to report on all six of the environmental objectives set out in the Taxonomy Regulation. The proposed CSRD would also apply to a much broader scope of entities than are currently required to report under the NFRD. The changes imposed by the CSRD are expected to be introduced and apply from FY 2023.

What corporates should be doing today

Compared with climate change, initiatives and legislation relating to the protection of natural resources are nascent. Corporates that are looking only to comply with their ESG obligations, and not to pursue best practice, need take no further action yet.

This would, however, be short-sighted. It is only a matter of time before objective standards (such as the TNFD framework) emerge which enable stakeholders to compare the sustainability of corporates' relationships with nature against objective benchmarks and against their peers. It is also inevitable that corporates will be forced to confront the impacts that their businesses have on the natural world beyond CO_2 emissions, and face the consequences if their operations are nature-negative.

In our view, corporates should be thinking about their relationships with nature – and, where appropriate, taking action – today. Corporates who are already thinking about these issues deeply will not only be best placed to comply with the nature-related obligations and disclosure standards that are introduced in the future, but will also be taking their responsibilities as custodians of responsible businesses seriously. Boards would be well advised to consider some or all of the following:

- **Honestly assess the impacts that their businesses have on nature:** While some sectors have faced scrutiny for many years over their impacts on nature, the net will soon be cast much wider. All corporates will need to 'look in the mirror' and honestly appraise the impacts that they (together with their global supply chains) have on nature, and whether their businesses are nature-positive or nature-negative. When the time of public reckoning comes, technical or 'cute' arguments about environmental impact (e.g. carbon offsetting, which itself contributes to reduced biodiversity) won't wash.
- **Act now to put their businesses on a sustainable footing:** If a business model is nature-negative, consider ways in which goods or services can be changed in order to be more sustainable. Companies which put nature-positive changes into effect as soon as possible will both maximise the nature-positive impact of the changes, and put their businesses on the best footing possible when required to make nature-related disclosures in the future.
- **Review their relationship with public funding:** If a business is currently reliant on public subsidy, consider whether that public subsidy is nature-negative or not. Nature-negative subsidies are likely to be significantly reduced over the course of the coming decade, and corporates should consider whether their businesses would be viable without those subsidies (and, if not, consider taking pre-emptive action). At the other end of the spectrum, nature-positive businesses (particularly those working on innovative nature-based solutions to climate change) will be well-placed to pick up additional public subsidy and nature-conscious private investment; corporates should consider pivoting towards nature-positive products and services where complementary to existing businesses.
- **Recognise their dependency on nature and the natural capital on their 'inclusive balance sheet':** Businesses should reflect on the extent to which their products and services rely on the free-of-charge goods and services provided by nature, and (if so) whether the relevant natural resources are under threat. If a business or its supply chain relies on a threatened natural

resource, consider how viable the business would be without free access to that resource (e.g. by assessing the cost of procuring non-natural alternatives) and consider what direct acts of conservation the business can take to reduce the level of threat posed to the natural resource on which it relies.

- **Shape the debate:** Corporates that are involved in the development of the TNFD framework will not only get to frame the discussion around what nature-related disclosures should look like, but will also get a head-start on what they will need to do to comply when the framework is published. Proactive corporates should monitor the nature-related space for other initiatives and consider getting on board at the 'ground level', if their interests are aligned and their expertise will add value.

If you would like further information about this topic, please speak to your usual Slaughter and May contact.

Jeff Twentyman
Partner

T +44(0) 20 7090 3476
E jeffrey.twentyman@slaughterandmay.com

Richard Hilton
Associate

T +44(0) 20 7090 3611
E richard.hilton@slaughterandmay.com

This briefing is part of the Slaughter and May Horizon Scanning series

Click here for more details or to receive updates as part of this series. Themes include: Beyond Borders; Governance, Sustainability & Society; Digital; Navigating the Storm; and Focus on Financial Institutions.