Could ESG reporting rules spark an EU-US trade war?

Nikko AM explores the implications for the green bond market

By Steven Williams, EMEA Head of Global Fixed Income
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The US presidential election in November continues to cast a long shadow, and as the race between the 45th (Donald Trump) and 46th (incumbent Joe Biden) presidents quickens, divisions have only widened. The investment world is no exception, and one particularly troubling battleground is the growing regulatory divide regarding environmental, social and governance (ESG) reporting.

Europe's Corporate Sustainability Reporting Directive

The issue centres on more comprehensive ESG disclosure requirements that will be introduced by the European Union (EU) in 2025. The EU's Corporate Sustainability Reporting Directive (CSRD) requires companies to disclose information about integrating social and environmental impacts, risks and opportunities in their business strategies, including climate-related ones. Companies will be required to offer a robust and detailed explanation if they conclude climate change is not material to their business.

The reporting requirements are being phased in in stages, starting with the largest organisations first, based on balance sheet total, net turnover and the number of employees. The first companies will have to apply the new rules for the first time in the 2024 financial year, for reports published in 2025. It is expected that under the CSRD, more than 50,000 organisations worldwide will have to begin disclosing information about their ESG practices. Companies in the scope of the CSRD will report accordingly to European Sustainability Reporting Standards (ESRS).

European Sustainability Reporting Standards

With the first set of ESRS required for financial year 2024 reports, companies are now expected to provide comprehensive disclosure on Scope 3 greenhouse gas (GHG) emissions. Scope 3 emissions are not directly produced by the company itself, neither are they resulting from assets owned or controlled by the company. Instead, they are emissions the company is indirectly responsible for up and down its value chain.

As you would expect, Scope 3 is where the majority of most companies' GHG emissions come from, but collecting Scope 3 emissions data is a challenge, as it requires a comprehensive understanding of the company's entire value chain. Therefore, companies are already preparing themselves to deal with this far-reaching reporting requirement.

A “watered-down” US version?

By contrast, in March, the US Securities and Exchange Commission (SEC) opted for a “watered down” regulatory reporting framework. Under original proposals, all publicly listed companies would have been required to calculate and report certain GHG emissions. However, now this will only apply to large businesses. Also, companies are now only required to disclose pollution from certain greenhouse gases if the corporations themselves consider the emissions “material”, or of significant importance to their investors, marking another key change from the draft proposals.

But arguably, the biggest divergence from the EU legislation is that US companies will not be required to disclose their Scope 3 emissions, or report on pollution generated by their supply chain or the consumption of their products.

The SEC has been accused of bowing to pressure from companies concerned about the burden that Scope 3 reporting would place on their business and supply chain, as well as pushback from Republican politicians who claim reporting standards are a form of government agency overreach.

For now, though, it seems that while Scope 3 reporting is not a requirement for domestic US companies, it could become a huge challenge for multinationals with operations in Europe. Although the CSRD will initially only apply to EU-incorporated companies, for financial years starting on or after 1 January 2028, non-EU companies with a significant presence in the EU must report emissions (including Scope 3) on a global basis, including all non-EU companies in the group.

Therefore, US companies with an EU presence will have some difficult decisions to make. They will have to determine how much emissions information to disclose and where and take steps to ensure their disclosures are consistent. This opens up the possibility of conflicting disclosure requirements between the CSRD and SEC rules, leading to potential fines and litigation.

While the CSRD will require capture emissions data from around 3,000 US companies from next year, the expectation is that, over time, this number will increase significantly. The disparities between EU and US regulatory requirements are exacerbated somewhat by the fact that in October 2023, the State of California passed its own climate disclosure bills directed at reporting entities that do business in California and which include similar Scope 1, 2 and 3 reporting directives as the EU version. The legislation notes that “California has an opportunity to set mandatory and comprehensive risk disclosure requirements for public and private entities to ensure a sustainable, resilient and prosperous future for our state”.

What does this have to do with the US Presidential Election?

Recent analysis by UK-based climate focused media platform Carbon Brief suggested a Donald Trump victory in November could result in an additional 4 billion tonnes of US carbon emissions by 2030 compared with Joe Biden’s plans.[1] It could also provoke a tit-for-tat trade war between the US and EU should the EU start fining US companies for failing to disclose Scope 3 emissions. Trump has initiated punitive tariffs on EU companies before, so he may be unlikely to resist the urge to do it again.

But regardless of who occupies the White House in 2025, the disparity between the different reporting requirements could lead to greater antagonism between the EU and US. And just as with recent objections to funding Ukraine, it could well become another wedge issue for Republicans at a time when geopolitics is already extremely tense.

Achieving a better balance of stick and carrot

You could argue that the US and EU are taking vastly different “stick and carrot” approaches to sustainability and the clean energy transition. In the US, the landmark Inflation Reduction Act (IRA) of 2022 has directed close to US dollar (USD) 390 billion in tax credits and incentives towards a sweeping range of clean energy initiatives, rewarding those companies with clean energy credentials. By contrast, the EU is pushing the regulatory aspect, and punishing those companies that are unable to demonstrate their own undertakings in terms of GHG emissions.

Perhaps there needs to be more of a balance struck between the two approaches, where companies feel better supported and offered incentives to disclose and reduce their emissions. For now, though, the EU continues to be the de facto leader on the subject of emission disclosures, given the absence of meaningful US participation in the overall narrative.

[1] https://www.eco-business.com/news/analysis-trump-election-win-could-add-4-billion-tonnes-to-us-emissions-by-2030/

Will this have an impact on the green bond market?

As we flagged in a recent article, with a market size of USD 4 trillion globally, but with a potential market size of more than USD 10 trillion by the end of the decade, the market dynamics make green and sustainable bond issuance impossible to ignore. Putting politics aside, it still makes clear commercial sense for companies to issue green and sustainable bonds, just as it still makes sense for us as fixed income investors to own them. We believe that the cost of energy production from green sources is superior, and we continue to make sure that the projects we fund through green bonds make economic sense, and that will continue to be the case going forward.

If you have any questions on this report, please contact:

Nikko AM team in Europe
Email: EMEAenquiries@nikkoam.com

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