

TECHNICAL EXPERT GROUP ON SUSTAINABLE FINANCE

SUBGROUP: BENCHMARKS

Progress Report

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Disclaimer

This report is a progress update. Nothing in this report precludes, prejudices or pre-empts any possible future reports from the Technical Expert Group on Sustainable Finance. Nothing in this report commits the European Commission nor precludes any policy outcomes.

I. OBJECTIVES OF THE TEG SUB-GROUP ON BENCHMARKS

The TEG sub-group on benchmarks **contributes to the implementation of the Commission's Action Plan on sustainable finance**. It will deliver a technical report by June 2019.

The report shall:

- **Provide minimum standards for the methodology of Low Carbon Benchmarks.** The group will define the key elements of the methodology used providing standards for the selection criteria, type and source of input data, methods used to weight,
- **Provide minimum standards for the methodology of Positive Carbon Impact Benchmarks:** how the company may calculate emissions savings, how to choose an appropriate baseline scenario against which the company's emissions savings are measured, what category of emissions may be included in saved emissions.
- Specify the **minimum content of disclosure for ESG benchmarks**

The Commission will launch a public consultation on the report provided by the TEG over the summer.

The report, together with feedback from stakeholders, will be the basis for the Commission's delegated acts.

II. MINIMUM STANDARDS FOR THE METHODOLOGY OF LOW CARBON BENCHMARKS (LCBs)

1. OBJECTIVES OF LCBs

LCBs are designed for risk reduction related to climate change. They demonstrate the following characteristics:

- Significant reduction in carbon intensity compared to their parent benchmark all along the supply chain (i.e. direct and indirect emissions)
- Broad and diversified investment suitable for various investors

2. TECHNICAL RECOMMENDATION

a. Carbon Footprint

Although Greenhouse Gases (GHG) are not the only source of environmental impact, limiting – and decreasing – their emissions is the most important challenge in the short term to tackle climate change and contain the rise in average temperatures to (well) below 2°C (UNFCCC 2015). Thus, emissions are one key indicator to assess a company’s exposure to climate risks. In a life-cycle approach, the exposure of a company to climate risks is not only a function of its internal manufacturing processes but also of the raw materials it uses, the quantity and nature of the energy it consumes (inputs) and finally the products and services it sells to its customers (outputs). The measure of emissions is often described as ‘carbon footprint’.

- Scope 1 emissions: All direct GHG emissions
- Scope 2 emissions: Indirect GHG emissions from consumption of purchased electricity, heat or steam
- Scope 3 emissions: Other indirect emissions, such as the extraction and production of purchased materials and fuels, transport-related activities in vehicles not owned or controlled by the reporting entity, electricity-related activities (e.g. Transmission and Distribution losses) not covered in Scope 2, outsourced activities, use of sold products, waste disposal, etc. There are existing international and European standards on the matter, i.e. ISO 14064 on standards for greenhouse gas accounting and verification, and the Product Environmental Footprint (PEF) and Organisation Environmental Footprint (OEF), that could serve for the calculation of scope 3 emissions.

- LCBs providers should ensure that data on all three scopes of emissions is obtained prudentially, is accurate and complete.
- When data is not provided by the companies either publicly self-reported or obtained through a survey or questionnaire, an estimated data should be used.
- Scope 3 emissions are especially important to consider in particular for sectors with high stakes regarding climate change and its mitigation (Oil & Gas, mining, transportation and buildings).
- Although there are some international standards on the matter, there is no consensus as to which standard to use for the calculation of scope 3 emissions. Therefore, estimations' methodology should be made fully transparent by the benchmark provider.

b. Carbon Intensity

To be compared from one company to another as well as to be aggregated at portfolio or index level, carbon footprints of individual companies need to be normalized using a financial metric. This metric can be sales, market capitalization, production volumes or enterprise value in a common currency.

- Total carbon intensity (scopes 1, 2 & 3): minimum reduction of 50% at index level relative to parent index
- Carbon intensity by scope (differentiated for each of the three scopes): Minimum reduction of 30% at index level relative to parent index
- To allow for carbon intensity comparison across LCBs, the group recommends using a standard normalization metric: e.g. Sales or Enterprise Value in a common currency

c. Sector and activity allocation constraints

Achieving minimum requirements set on carbon intensity at index level could be possible by simply divesting from carbon intensive sectors to sectors with very little carbon intensities. As one of the key objectives of LCBs is to shift capital from carbon intensive assets towards solutions necessary to the energy transition, weighting schemes of these benchmarks should not allow for a simple divestment from sectors key to this transition. In other words, sectors with marginal impacts on climate change and its mitigation should not be overrepresented in a Low Carbon Benchmark compared to its parent index.

- Exposure to sectors that are key to the low-carbon transition and exposure to green activities are equal or greater than for the parent index

d. Tracking Error

The primary objective of setting this technical requirement is to fight against greenwashing. The sub-group is currently discussing several possible constraints to achieve this objective without harming the attractiveness of LCBs for investors. The justification below is for introducing a minimum tracking error but this idea will be tested with stakeholders to confirm it will not introduce unexpected negative consequences. In addition, the sub-group is also exploring the complementary use of active share to meet the objective.

Ambitious carbon-related benchmarks are built to shift significant amounts of capital from fossil-fuel dependant activities to more carbon-efficient activities, notably in the fields of renewables and energy efficiency. Low levels of tracking-error mean a close replication of the financial behaviour of the parent index. While objectives set on carbon intensity and sector allocation directly address the issue of carbon performance of indices, the integration of a minimum level of tracking-error ensures a true deviation from the parent index in terms of financial characteristics and thereby prevents aggressive forms of greenwashing. Meeting ambitious targets in terms of carbon intensity reduction should not be compatible with very low levels of tracking error that demonstrate replication strategies.

- Tracking Error constraint: minimum 30 or 50 basis points relative to the parent index

e. Trailing Error

The sub-group is considering the addition of a maximum trailing error which can help protect branding of LCBs so that significantly underperforming indices cannot be branded as LCBs. This would take the following form:

- Trailing Error constraint: maximum 400 or 500 bps to protect investors and fulfill fiduciary duty

f. Sector Exclusions

The sub-group is not recommending the exclusion of any sector as a minimum standard but is considering the following to address potential reputational risks:

- Exclude companies that have 50% or more of revenues generated from coal

III. MINIMUM STANDARDS FOR THE METHODOLOGY OF POSITIVE CARBON IMPACT BENCHMARKS (PCIBs)

1. OBJECTIVES OF PCIBs

PCIBs standards follow a single overarching principle of having more carbon savings than carbon emissions. PCIBs demonstrate the following characteristics:

- Saving more emissions than emitting at each asset level that makes up the benchmark,
- Narrow investable universe suitable for more specialized users and investment strategies

2. TECHNICAL RECOMMENDATION

a. Emissions Savings

While the carbon footprint of a company is an indicator of its impact on / contribution to climate change, it does not indicate whether this company contributes to the reduction of overall carbon emissions needed to avoid the catastrophic consequences of climate change described by the IPCC. In other words, the carbon footprint of a company is a measure of its negative impact while its emissions savings is a measure of positive impact.

Ambitious climate scenarios in which the rise in average global mean temperature does not exceed 1.5°C in the long run (IPCC SR15) always imply massive reduction of overall carbon emissions performed by both a decrease in carbon-intensive assets and an increase in “carbon-effective” assets related to renewables and energy efficiency. An investment strategy that is aiming to contribute to these ambitious climate goals should therefore not only integrate a measure of negative impact (carbon footprint) but a measure of positive impact (emissions savings) as well.

While carbon footprint has gained a lot of traction and has been continuously improved and further defined since many years already in the investment community, the notion of emissions savings lacks harmonized definitions and consensus.

Emissions savings are always the difference between the carbon footprint of an activity and a reference scenario. The construction methodology of any carbon related benchmark including emissions savings shall clearly mention the calculation methodology for emissions savings. The reference scenario used should be precisely described by the index provider.

- Emission Savings > total carbon intensity for each individual asset in the index

b. Sector Exclusions

Similar to the discussion with regards to the minimum requirements for low carbon benchmarks, the subgroup is also reflecting on this element but is not recommending excluding any sector a priori.

IV. MINIMUM DISCLOSURE REQUIREMENTS FOR ESG BENCHMARKS

1. OBJECTIVE

Today, different levels of ESG transparency on benchmarks methodology make it difficult for market players to compare indices and select the adequate benchmarks for their investment strategy.

All ESG benchmarks are subject to the following disclosure requirements of minimum ESG content to be made available in the public documents as specified by the Benchmark Regulation (BMR): the key elements of the document describing the methodology and the benchmark statement.

2. TECHNICAL RECOMMENDATION

- a. Overall ESG rating disclosure – aggregated, weighted average at benchmark level, and how it is included in the benchmark’s construction
 - Overall ESG, E, S, and G ratings, the provider of the ratings, link to the rating methodology description, with special focus on the parent/subsidiary rule, and how it is included in the benchmark’s construction
 - Distribution scale of each ESG rating (0-100, D-A, etc.)
 - Coverage percentage of ESG rated companies in the benchmark relative to the parent index
 - Any index that refers to the support of UN Sustainable Development Goals (SDG) should disclose which SDGs are supported, including the number, if it generates a positive or negative impact
- b. Environmental KPIs – aggregated, weighted average at a benchmark level
 - GHG disclosure – scope 1, 2, and 3 emissions, percent actual vs estimated emissions, avoided emissions, as well as coverage percentage of companies in the benchmark relative to parent benchmark
 - Scenario Alignment of the benchmark, methodology used

- c. Social KPIs – aggregated, weighted average at a benchmark level
 - Compliance with minimum human rights standards (ILO, Universal Declaration of Human Rights, UN Convention Against Corruptions, etc.)
 - Controversial business involvement (Controversial Weapons, Nuclear, Coal, etc.)

- d. Governance KPIs – aggregated, weighted average at a benchmark level
 - Alignment with minimum governance standards (board independence %, Chairman/CEO separation %, one share/one vote rule, external auditor independence, executive remuneration, etc.)

V. OUTREACH PLAN AND CONSULTATION STRATEGY

1. ROUNDTABLES WITH ASSET OWNERS, ASSET MANAGERS AND BENCHMARK PROVIDERS

The sub-group has decided to organise three round tables with i) **asset owners**, ii) **asset managers** and iii) **benchmark providers**.

The first roundtable took place with asset owners in October 2018.

The roundtable with asset owners that took place in October 2018 had three main objectives:

- Understand whether asset owners already have a carbon strategy,
- Collect more input about the data/methodologies available/used by the market (iii) what asset owners need to allocate significant part of their capital to funds tracking the proposed low-carbon and positive carbon impact benchmarks and
- Highlight what they see as the main challenges.

Several asset owners from different European countries participated in the roundtable.

They strongly support the objective to reduce carbon footprint. They have more reservations on a benchmark that could be aligned with the Paris agreement due to the lack of existing and sound methodology that would allow to pursue such a strategy.

The general conclusion of the discussion, on data, is that the quality and reliability of data for greenhouse gas emissions should be improved. In addition, they mentioned that the minimum requirements for the methodology of carbon benchmarks should address the situations where the data is not available (i.e. issue of estimates).

Asset owners also stressed that the actions of the European Commission should not hinder the level of competition. They reminded that any benchmark should take into considerations risks.

They support the objective to increase the level of transparency of ESG benchmarks. However, they do not recommend specific ESG disclosures to be required for all benchmarks.

2. OTHER CONSULTATIONS

In addition to the roundtables, the subgroup sent a **detailed and extensive questionnaire to carbon data providers** on the existing methodological requirements to calculate the carbon

footprint of a company. The sub-group wishes to understand how they measure the carbon footprint of a company (especially considerations on the methodology used, the scope of emissions and the use of forward-looking and/or historical information) and the data gathering process.

The interim report will also be **shared with the Member States expert group** in February for comments and feedback.

Finally, an **open consultation of the interim report** will be conducted in March 2018.