CDP Europe's comment on the draft technical advice on minimum requirements for the EU climate-transition benchmarks and the EU Paris-aligned benchmarks and benchmarks' ESG disclosures

Background

CDP welcomes the work the European Commission and Parliament have been developing in addressing the gaps that currently exists concerning the transparency and impact of the financial system and its role in the necessary Ecological Transition, namely as part of the Commission's Action Plan on 'Financing Sustainable Growth' (the Action Plan). The introduction of regulation is critical in the creation of a broad movement towards aligning investment expectations with the constraints of limited planetary resources, by channelling investments into regenerative activities and assets while decreasing and ultimately stopping investment in unsustainable ones.

In this context, CDP welcomes the work and interim report of the Technical Expert Group on Climate Benchmarks and benchmarks' ESG disclosures of June 2019 ('the report'), as well as the opportunity to comment on it. **Our overall appreciation of the report is that, although relevant, as the presented current proposal is lacking on conceptual clarity, practicality and, if advanced in its current form, might lead to substantial confusion in the marketplace potentially undermining its purposes**. We have structured below the main areas of CDP's feedback that explain the reasons for our generic position on the report.

Objectives of the report, ESG and climate benchmarks

Concerning sustainability benchmarks the Action Plan registers two actions on the development of sustainability benchmarks: (i) adopt delegated acts, within the framework of the Benchmark Regulation, on the transparency of the methodologies and features of benchmarks to allow users to better assess the quality of sustainability benchmarks; and (ii) put forward (…) an initiative for harmonising benchmarks comprising low-carbon issuers, based on a sound methodology to calculate their carbon impact, to be put into operation once the climate taxonomy is in place.

The report proposes: 1) the creation of two types of climate benchmarks - the EU Climate Transition Benchmark (EU CTB) and EU Paris-aligned Benchmark (EU PAB); and 2) the definition of Environmental, Social and Governance (ESG) disclosure requirements that shall be applicable to all investment benchmarks; with point (i) and (ii) of the Action Plan being addressed by point 2) and 1) of the report, respectively.

The two issues raised by the Action Plan – transparency of ESG Benchmarks and Climate benchmarks – are related and connected, but this connection is not addressed explicitly and clearly neither in the Action Plan or the report. It is advisable to explicitly highlight this connection; Namely, it would be **important to reflect on 1) the notion of sustainability when talking of an ESG benchmark; 2) if an ESG benchmark necessarily needs to be "Paris compliant" or not, as a basic requirement** (this second point is addressed later in this document).

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The notion of sustainability for ESG benchmarks

When talking of sustainability benchmarks, it is important to have a practical definition of sustainability which addresses, at least, the spatial and time scales that are being assessed[1]. While the spatial scale might seem obvious – global, in line with how the financial system works, its impacts and the nature of the current economy – its temporal scale is less certain. If companies work often at time scales which seldom encompass 1 to 3 years, investment is often made at much shorter time scales, often not even meaningful for a human being (e.g. high-frequency trading). Any of these scales are much shorter than the scale of infrastructure in the economy or the nature of the many physical processes currently being disrupted in fundamental ways. This mismatch of time scales has recently been widely and amply acknowledged in the financial community, namely by Mark Carney speech on the “Tragedy of the horizons”[2].

Especially climate risks or opportunities that are unlikely to materialize over the next few years, but could be significant over longer horizons, tend to be under-priced or underappreciated by investors. This discrepancy is to be addressed on finance in order to better align it with the needs of people living within finite planetary resources – through **disclosure requirements on the time scales involved in the definition of any sustainability benchmark or concrete recommendations on the time scales suitable in the creation of those benchmarks need to exist**.

Clarity on use of terminology

We find that the report is sometimes confusing as it uses ambiguous language when talking about benchmarks, disclosures and data. Although the report has the ambition to address ESG benchmark indices for different asset classes, it mainly focuses on equity or discusses equity related challenges. On equity (listed companies), we believe it is important to be very clear on use of terminology. When talking about ESG benchmarks we can be talking of the specific rating of the equity (e.g. is the company in CDP A list) or a specific portfolio of companies that have been selected using a “benchmark methodology”. The two are significantly different and can be referred to as “benchmarks”. Same thing applies to “benchmarking methodology”, disclosure and data.

In our view, there is **a cascade of both data, disclosure requirements and methodologies that should be clearly laid out** in order to distinguish the (many) different layers. We illustrate this in the following picture:

[1] See for example Bell and Morse (2008), pp.14 and 15 - “… there are two questions that need to be answered before achieving sustainability: 1) Over what space is sustainability to be achieved?; 2) Over what time is sustainability to be achieved? The answers to these may, at first, appear rather obvious (…) the difficulty is that these scales are all interlinked. The smaller the scale the harder it is to know where to draw the line.” - or Heinin (1994), pp. 31 – “Sustainability must be made operational in each specific context (e.g. forestry, agriculture), at scales relevant for its achievement, and appropriate methods must be designed for its long-term measurement.”
[2] https://www.bankofengland.co.uk/speech/2015/breaking-the-tragedy-of-the-horizon-climate-change-and-financial-stability

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Index performance tracking Index composition Index disclosure requirements Index benchmark methodology and criteria	Equity Indices
↑	
Company ESG rating Company rating methodology Company indicators Company indicators computation methodology	Equity ESG ratings and benchmarks
↑	
Company publicly disclosed data Company data	Equity data and disclosure requirements

While the report should be focusing mainly on "Equity Indices" and their disclosure requirements, it talks about these different layers without clearly distinguishing them which is confusing and ambiguous at times. A specific Equity ESG Rating benchmark methodology can become an Equity Index (e.g. DJ Sustainability Index), while there are publicly available ESG ratings (e.g. CDP corporate ratings) who do not have ambition to become Equity Indices but can be used as sole input or input components of equity indices. These different types of data, methods and their uses should be clearly identified and differentiated.

Minimum ESG Disclosures

CDP finds that the list of ESG factors is generally correct, but that for **all ESG factors there should be requirements to disclose not only the performance on that specific factor, but also the methodology and data used to calculate them**[3]. In fact, only in this way it can address the concern stated in the Action Plan that "index providers have been developing ESG benchmarks (…) but the lack of transparency regarding their methodologies has affected their reliability".

CDP agrees with the classification of asset classes but is not able to follow the rationale for exclusion of certain disclosure factors in the overall list and why some apply to certain asset classes and not to others. We also find that many of the disclosure requirements are insufficiently defined in terms of their practical application, as there will need to be significant methodological innovation in order to apply them to specific contexts.

[3] Appendix C provides "Further details and guidance on the factors to be reported" on the ESG factors. We note that the guidance is short in detail and that sometimes it adds additional disclosure requirements for methodology to calculate the factors (8 out of 27 ESG factors) and for us it is not clear why some factors do not include this methodology requirement as none of these factors is trivial in their evaluation/assessment. We also think that disclosure requirements should not be included in Appendix C if it is intended to provide guidance. Disclosure requirements should be included in section "3.3.2 Detailed minimum disclosure requirements table".

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As an example, "% of UNGC violations" we assume refers to the 10 UNGC high-level principles concerning Human-rights, Labour, Environment and Anti-corruption[4]. It is not clear to us how those principles are assessed, as per each of the principles significant data and methodologies could have to be built in order to express such requirement on a % basis at an index level. It is contradictory that "% of UNGC violations" is required, but then the ESG Factor "Human Rights (Index)" is excluded for Equity. We assume it is because in fact, there is a Human Rights Index for countries but not one that is usable for corporates[5]. But is it the fact that there is not a Corporate Human Rights Index a reason to exclude it as an explicit disclosure factor from equity indices disclosures? CDP believes it is not and Index providers should be clear on how they are considering Human Rights issues. The disclosure on "% of UNGC violations" would be clearly ambiguous to this respect: how are such % calculated or how are the principles assessed, e.g. how are businesses assessed against "Principle 1: Businesses should support and respect the protection of internationally proclaimed human rights" or how are they assessed on "Principle 7: Businesses should support a precautionary approach to environmental challenges;"? In an Index of 10 companies, if one company violates one of the 10 principles, would that count as a disclosure of 10% UNGC violations (1/10 companies in violation) or 1% UNGC violations (1 company violating 1 principle out of 10 companies x 10 principles)?

Overall, **we find a high degree of discretionary judgement has been used in the "inclusion/exclusion" of ESG factors disclosure requirements**, which may or may not be sensible per each asset class. We find that ESG factors might not have been thought of as "broad categories" of theme relevant areas, but more on a pragmatic and heuristic fashion of what can be done now. We have already referred to the human rights issue for equity, but we could also refer to "Controversial weapons" or "Fossil Fuel exposure" or "Green revenues" (in this case GDP) that we believe would apply also at country level (Fixed income - SSA) but have been excluded of the list of disclosure factors. We note for example, that the list of criteria that applies to commodities is considerably reduced, which we are not sure is justifiable.

We also note that ESG Indices may be "sustainability theme specific", e.g. climate or human rights specific. In those cases, we see the rationale to disclose information about some of the other themes (e.g. a climate index to disclose how it performs on human rights). What is more **difficult to understand than is why the disclosures apply only to "ESG benchmarks" and not to all financial indices** – which is what should be required if ESG is to move beyond a niche financial market. We understand that the mandate of the Action Plan has framed this as an ESG specific issue

> *"**Traditional benchmarks reflect the status quo and their methodologies, as a result, reflect sustainability goals only to a limited degree**. As such, **they are not appropriate to measure the performance of sustainable investments**. **In response, index providers have been developing ESG benchmarks to capture sustainability goals, but the lack of transparency regarding their methodologies has affected their reliability.** More transparent and sounder sustainable indices' methodologies*

[4] The report states in Appendix C ESG Disclosure Factors: "Weighted average percentage of index constituents violating the principles of the UN Global Compact".
[5] We acknowledge the existence of the Corporate Human Rights Benchmark, while recognizing that an insufficient number of companies might be currently rated for the inclusion and use of such benchmark(s) into an Equity index.

are needed to reduce greenwashing risks. For instance, a sound methodology for low carbon indices should reflect compatibility with the objectives of the Paris Agreement, in order to improve the performance assessment of low-carbon funds."[6]

but somewhere it should be noted that the issue is not only one of lack of transparency of ESG benchmarks but of lack of transparency of ALL benchmarks in relation to sustainability indicators. In that respect we welcome Art. 27 of regulation amending regulation (EU) 2016/1011, as noted in section 3.5 of the report, that requires an explanation of how the methodology of ALL benchmarks "aligns with the target of carbon emissions reductions or attains the long-term global warming target of the Paris Climate Agreement". We believe a similar recommendation should have been made in relation to key ESG factors.

Inclusion of water-related and biodiversity metrics as part of Environmental disclosure ESG factors

The environmental disclosure factors seem to be clearly biased towards the topic of climate change. We believe that it would be better in that case to call it "climate disclosure". However, given that the focus is on ESG benchmarks, we believe that the E ("Environment") part of the disclosure needs to be broaden up beyond climate-related aspects and that the TEG should consider at least the inclusion of:

- a water disclosure metric, the rationale for this is that the health of natural water bodies is critical for ecosystems, human development, as well as critical to achieving the Paris Agreement and 1.5-degree future;
- a biodiversity disclosure metric, the rationale for this being that biodiversity is a critically threaten planetary boundary and a key indicator of the health of an ecosystem.

EU Climate Transition and EU Paris-aligned Benchmarks

We welcome the ambition on having what is in practice a label for "EU Paris-aligned" Benchmarks and also that this label would be applied to all benchmarks (with exception of currency and interest rate). However, we do also have serious concerns on the feasibility and adequacy of some of the recommendations in the report, namely:

On Issuers and asset classes in scope of climate benchmarks minimum requirements (5.1.2)

We believe that sovereign-based issuance indices and private market indices should be in scope; lack of data should not be a reason to stop the obligation for these indices to demonstrate their alignment; only in this way can we actually move the financial system towards higher levels of transparency on what assets are being funded;

In particular lack of "carbon footprint" data is neither necessary or, in many cases, desirable; it should be avoided to wait for "carbon footprint" data on investment decisions as, by that time, it might be too late; carbon footprints are backward looking and, although having considerable value in assessing impact, cannot and should not be the sole measure of carbon impact;

[6] European Commission Action Plan 'Financing Sustainable Growth', page 7

In particular in the context of sovereign bonds, particular emphasis should be put on committed carbon forward, this is, a measure of the amounts of carbon a particular programme or policy for which financing is being requested is going to emit in future; many governments worldwide are making considerable expansions of their coal capacity and such policies have no reflection on their cost of capital.

On USE CASES AND OBJECTIVES (5.2)

The TEG should consider adding a corporate disclosure/transparency objective, as high-quality disclosure of climate impact and related risks or opportunities by corporate issuers is a pre-requisite for building meaningful and trustworthy CTBs or PABs.

A key issue today is that financial markets do not provide adequate incentives for corporate issuers to (a) measure GHG emissions comprehensively and accurately, (b) set meaningful emissions reduction targets and (c) reduce absolute greenhouse gas emissions.

Therefore, the creation and market adoption of CTBs and PABs should create incentives for corporates to be transparent about their impact (accurate measurement of Scope 1, 2 and 3 emissions) and their strategies to reduce their impact in the future.

The TEG should consider including in its minimum standards for CTBs and PABs the inclusion of a requirement to include/overweight those companies with accurate and complete measurement of GHG emissions and ambitious absolute emissions reduction targets. The level of ambition of an emission reduction target against temperature goals can be measured already today.

A transparency objective would also be aligned to the ambitions of fostering better climate-related disclosures through the TEG's updated non-binding guidelines to the Non-Financial Reporting Directive.

On Technical advice on the calculation of carbon intensity (5.3.3)

We would like to bring to the TEG's attention the fact that introducing Total Capital as the denominator in the calculation of carbon intensity is not aligned with the recommendations of the Task Force on Climate-Related Disclosures. The TCFD recommends asset owners and asset managers report to their beneficiaries and clients the weighted average carbon intensity of their portfolios expressed in tons CO_2e / $M revenue.

On Technical advice on carbon intensity for climate benchmarks (5.3.6)

CDP does not understand how the minimum reduction of 50% of GHG intensity applies – is it at any given moment? Is it a target for the index by a given date? – and what the rationale for it is. If the 50% reduction in intensity compared to investable universe applies at any given point in time, then it is welcome, but we do not understand how it is compatible with the requirement put forward in 5.7.1 (weighting constraints). If the requirement is for reduction by a given date, then it seems contradictory to express it in terms of reduction relative to the investable universe – one would need to know what the expected reduction is for the investable universe to know if it is Paris-aligned.

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In all cases, the justification provided is one of authority (“after consultations and roundtables with asset managers”), while we believe there should be a clearer rationale for the recommendation that is a key component of the minimum technical standards for EU PABs (5.10).

A 50% reduction by 2030 might be considered appropriate, although it will depend on what is the growth of the denominator (total capital); if total capital (book value) grows at same pace of economy say, the usual 3% that economists often use for long-term economic outlook, then in 10 years total capital will grow by 30% and the amount of reductions needed to meet the Paris agreement’s requirements are considerable higher than what the target implies. If it is a 50% reduction by 2050, then it seems wholly inappropriate.

On Technical advice on dynamic decarbonization for climate benchmarks (5.5.2)

The report should explain better the use of inflation as a factor to adjust the decarbonization rate and what inflation rate should be considered in the calculation of different benchmarks with varying geographical exposures.

On Rationale for weighting constraints (5.7.1)

Given that the use of Indices (particularly equity indices) is usually considered as a “passive” investment strategy and that there is value in the production of “specialized” indices in parts of the economy, CDP does not understand the proposal to constraint sector allocations. We would note that: 1) the proposal might or might not make sense, dependent on the specific sector classification and what is, or what is not, within a sector; 2) for some sector classifications, we would foresee it to be extremely difficult for an index to follow the rate of decarbonization required without having to significantly adjust its composition; 3) given that indices are passive investment strategies, isn’t this shift of capital one of the main objectives?; 4) if all indices need to be labelled according to their alignment with Paris, does this mean that only indices that invest within the sector constraints can become EU PABs and that current ESG or climate indices that do not meet that requirement will not qualify?

The constraint is counter-intuitive and contradictory. One would say that it leads to lock in the old economy and that it is far from market consensus. Why do investors still need to invest in Coal, Oil and Gas or infrastructure that lock us down in a carbon intensive economy in a Paris-aligned benchmark?

The use of GICS classification in “Table 8: Sectors GICS level2 classified by climate impact” is not market neutral, as GICS is a proprietary classification system and its use at level 2 requires the acceptance of license agreements and payment of fees. Furthermore, the consideration of financial companies as “Low climate impact sectors” can only be explained if considering their direct emission impact. The financial system actors have a fundamental role in the finance for the “high-carbon economy” as well as the “low-carbon economy” and we would dispute that their climate impact can be assessed purely based on their direct emissions. We believe that the classification of banks, diversified financials and insurance sectors as “low climate impact sectors” is contradictory with the efforts the EU is doing on the long-term sustainability of the financial sector.

On GREEN TO BROWN RATIOS (5.8)

While CDP welcomes the introduction of measures other than carbon foot printing like the green to brown ratios, we do not understand the rationale behind a factor of 4 for EU PABs or a factor of 1 for EU CTBs. The IPCC graphic referenced in this section, refers largely to investments in new assets. Most of the discussion seems to be focused on equity. For equity Green to Brown ratios typically reflect revenues from companies from specific assets/activities that do not necessarily translate into investment. If the economy is to decarbonize by 2050, as IPCC's 1.5 report indicates is needed to meet 1.5ºC, then for sure the green to brown ratio of any indices in terms of the revenues of their constituents will need to be much higher than 4! In fact, one could argue that green to brown ratios could be a suitable indicator to track the performance of indices – maybe better than a carbon intensity – and that by 2050 the brown to green ratio needs to equal zero.

Green to Brown ratios might have to be quite different for different asset classes, for example, private debt and infrastructure. We believe this is an area that needs further research and justification in order to be able to produce the necessary guidelines.

We are at the European Commission's and the Technical Expert sub-group's disposal to provide further input and evidence.

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