



Net Zero Asset Owner Alliance response to TCFD Consultation on “Forward Looking Financial Metrics”

THE UN-CONVENED NET-ZERO ASSET OWNER ALLIANCE

The United Nations Net-Zero Asset Owner Alliance (the Alliance) was established at the Climate Action Summit in New York in September 2019 by UNEP FI and PRI with a group of 12 founding members. The Alliance is now comprised of 33 institutional investors, representing \$5.1 trillion assets under management, all committed to delivering on a bold commitment to transition their investment portfolios to net-zero GHG emissions by 2050, consistent with a maximum temperature rise of 1.5°C above pre-industrial levels.

Together UNEP FI and PRI provide the secretariat functions of the Alliance. The Alliance is UN-convened, and AO led. Therefore, all AO members, alongside the UN-affiliated conveners, have wide-ranging responsibilities to contribute to the Alliance, its governance, its strategy, and the execution of its intended actions.

More information: <https://www.unepfi.org/net-zero-alliance>

ENDORSEMENT OF PRI AND UNEP FI POSITIONS ON FORWARD LOOKING METRICS

The Alliance members have reviewed the responses prepared by the PRI and the UNEP-FI, which themselves are the Alliance’s conveners, and elected to endorse these positions. The open letters put forward by the PRI and UNEP FI provide adequate explanations. Nonetheless, we summarise these recommendations below. These are fundamental to ensuring work on forward looking metrics develops in an appropriate manner and will thus ensure it becomes a useful metric to support Alliance members efforts to monitor, manage, report, and communicate their progress towards their portfolio decarbonisation targets.

Main PRI recommendations

1. Provide clarification for financial institutions on the purpose and appropriate use of forward-looking metrics.
2. Provide a distinction between the needs of the end user of forward-looking metrics.
3. Clearly define the use case for the Implied Temperature Rise (ITR) metric, given the absence of a transparency of inputs and a common methodology between providers, at present, limits its ability to track progress towards climate goals.
4. Summarise alternative metrics and the use cases of these as forward-looking metrics.

5. Distinguish between forward-looking metrics and targets. Potentially any forward-looking metrics, which is disclosed, is also a target, even if it is not formally recognised as such. Future TCFD guidance should look to clarify the distinction and interaction between the two.
6. Ensure consistency is maintained with non-financial metrics.
7. Development of a TCFD metrics dashboard would be an invaluable resource.

Main UNEP FI recommendations

1. Promote the standardization of disclosures and key metrics, notably via the creation of a “TCFD dashboard”, in coordination with the relevant standards.
2. Promote the inclusion of an implied temperature rise (ITR) metric in TCFD reports, despite caveats expressed in the TCFD consultation document, to provide important insights on alignment*.
3. Promote the production of “decision-useful” scenario analyses based on relevant metrics including climate value at risk (VAR) for investors, and requiring further definition of the scenarios, temperatures, time-horizons, and loss metrics within scenario analysis.
4. Promote the use of alignment metrics as a useful tool to deepen understanding of various risks, such as credit, market, reputation, and operational risks, beyond climate impact.
5. Promote use of ITR to drive “real climate action” beyond the TCFD’s “theory of change” (climate risks will be better priced and managed in markets with better information about these) by encouraging meaningful climate goals supported by regulators and stakeholders*.

* Alliance members insist on essential clarification regarding the use case of this metric, in line with PRI point 3. More generally, the UNEP FI and PRI express support for the TCFD to continue to develop its guidance around forward-looking financial sector metrics.

ENDORSEMENT BY THE ALLIANCE’S “WARMING METRICS” SUB-TRACK OF FORWARD LOOKING METRICS AND CONNECTION TO LONG TERM ALLIANCE GOALS

The Alliance members have collectively committed to “climate neutrality” in their investments by 2050, also understood as achieving 1.5°C “Implied Temperature Rise” (or equivalent to “aligning portfolios with a 1.5°C scenario”) within this timeframe¹. As a result, the Alliance is interested in ensuring that

¹ This long-term alignment target is now complemented by the Alliance’s “intermediate” target framed within its “Target-setting Protocol”, itself based on a carbon footprint-type metric. More information:

<https://www.unepfi.org/wordpress/wp-content/uploads/2021/01/Alliance-Target-Setting-Protocol-2021.pdf>

adequate forward-looking metrics emerge and stabilize². This response is developed in this context and is focused on “Implied Temperature Rise”.

The Alliance created a “Warming Metrics” sub-track dedicated to investigating portfolio alignment / “temperature” methodologies which leverage forward-looking metrics. The TCFD consultation is relevant to the remit of the ‘Warming Metrics’ sub-track.

In addition to the above endorsements and individual Alliance members’ responses, the Alliance emphasizes the potential of forward-looking metrics and expresses its full support of standardization and development of forward-looking metrics (alongside other metrics measuring the carbon footprint / intensity of investment portfolios), and in particular, of the ‘Implied Temperature Rise’ metric.

Caveats regarding forward-looking metrics (not limited to ITR) are well developed in the TCFD consultation and are highlighted in PRI’s and UNEP-FI’s response. These relate to a lack of reliable emissions data, a lack of transparency and comparability, a reliance on assumptions and future uncertainty, complexity of calculation, and suitability for public disclosure. These caveats, combined with different methodology assumptions, lead to divergent results, which hampers use of ITR in investment strategies. Therefore, it is important that the advantages and disadvantages of each metric are continued to be highlighted throughout the further process as metrics will further mature.

As long as the use cases and the alignment of the metrics is under work, we strongly recommend that the uncertainties on the forward-looking metrics are made transparent and to leave the decision to the reporting company to what extent and in what form such metrics are publicly disclosed. However, Alliance members believe forward-looking metrics could be powerful tools, enabling investors to better understand the “climate dynamics” of portfolio companies beyond the “static” carbon footprinting, and once methodologies become standardised, to develop targets which can connect to global climate policy goals, i.e., “net-zero” by 2050 and a +1.5°C by the end of the century. While different metrics serve different purposes, and several metrics will likely be needed, “Implied Temperature Rise” is a concept to consider if methodological challenges are met in the future.

ALLIANCE PROMOTION OF IMPLIED TEMPERATURE RISE METHODOLOGY PRINCIPLES

For Alliance members to monitor progress and report against their 1.5°C target, members express a need to develop robust, transparent and convergent measurement methodologies based on reliable data.

² See also reports from Institut Louis Bachelier (“Alignment Cookbook” <https://www.louisbachelier.org/wp-content/uploads/2020/07/rapport-0607.pdf>), Portfolio Alignment Team (“Measuring Portfolio Alignment”, <https://www.tcfithub.org/wp-content/uploads/2020/10/PAT-Report-20201109-Final.pdf>) and Investor Leadership Network (Climate Change Mitigation and Your Portfolio, https://www.investorleadershipnetwork.org/wp-content/uploads/2020/09/ILN_Climate-Change-Mitigation-and-Your-Portfolio.pdf)

Therefore, the ‘Warming Metrics’ sub-track also wishes to provide the TCFD with extra recommendations regarding ITR by leveraging the significant work it has undertaken since Q1 2020 to this end.

The Alliance developed core methodology principles, listed below; the full document is available online (https://www.unepfi.org/wordpress/wp-content/uploads/2020/11/AO-Alliance_Request-For-Comment-on-Methodological-Principles_Live-V2.pdf).

They relate to many of the elements developed in the TCFD’s forward-looking metrics proposals.

We strongly encourage the TCFD members and secretariat to reflect on these principles. The use of, and methodology convergence around, these principles is encouraged by the Alliance members, representing over \$5 trillion AUMs, all committed to the 1.5°C goal outlined above.

Core principles

1. Impact.

- The methodology must provide investors / users with a quantified view of the impact of their investments on climate change. This is generally described as an “inside-out / impact” approach, which differs from more traditional “outside-in / VaR / risk” approaches. However, NZAOA members, as long-term institutional investors, act in the belief that ultimately those two approaches necessarily converge: investment strategies that degrade ecosystems will harm long-term investment returns.
- The quantification of the alignment of a company’s activities against the pathway commensurate with a 1.5°C temperature rise is key for asset owners’ beneficiaries and asset managers’ clients in understanding climate-related risks associated with individual funds, products, and investment strategies.

2. Forward-looking.

- The methodology must provide investors / users with a forward-looking metric.
- As a result, the nature of the metric is expected to require integrating forward-looking data such as sectorial and geographical GHG reduction requirements, Capex, green revenues, green share / brown share as well as public corporate commitments to “decarbonize” business mix in the “real economy”, for example in line with technology shifts derived from the EU Taxonomy, per sector.
- Methodologies that are unable to factor such strategic reorientation commitments, especially those with a shorter timeframe, will not be considered compatible with the methodological principles. Static assessments are sensitive to the year of assessment chosen and do not inform on past and future climate performance.

3. GHG footprinting.

- GHG emissions footprinting must form the basis of this methodology; GHG Protocol Scopes 1 and 2 must be included.
- Scope 3 emissions (eg “upstream” and “downstream” / product-related emissions) should be covered at least for sectors where these are material (>40% of total emissions).
- With respect to Scope 2 and 3 emissions, how potential double-counting of emissions is identified and treated should be clearly explained and justified.
- With respect to all GHG emissions data used, the sources of that data should be identified as well as how the completeness and accuracy of the underlying data is validated.
- The NZAOA expresses a preference for footprint intensity normalization rules based on Enterprise Value. This is also the approach pursued by the EU within taxonomy-related developments.
- Principles 2 and 3, in combination, require that forward-looking metrics are translated into future carbon footprint implications. Assumptions around this translation should be clearly explained.

4. Portfolio alignment / investment “temperature”.

- The methodology may produce several KPIs and qualitative insights, but it must deliver a “core” metric expressed in terms of a forward-looking carbon intensity KPIs (both relative to production and absolute) as well as temperature KPI, for users to assess considerations around “portfolio alignment” with the Paris Agreement.
- See also “Coverage” section below for asset class aggregation concerns.

5. Science-based decarbonization.

- The methodology must be based on adequate IPCC scenarios and seek to promote “real world impact” by encouraging investment decisions that lead a decarbonization of the economy. While the sharing of emissions responsibilities and emissions reductions must be explicit and explained, it is however understood that “real world” impact requirements are currently challenging.

6. Portfolio management.

- The methodology must allow to compare single companies in a given sector and decide which company is better aligned towards net-zero by 2050 or an implied temperature rise of 1.5°C, as a basis of all investment decisions. This requirement effectively rules out methodologies which are based on estimations per sector alone.
- While initiatives such as SBTi are preferably expressed at sector or asset class level, this metric must be able to be expressed at individual issuer and portfolio levels (including multi-asset class portfolios) and may also be extended at an asset class level. The metric must make sense at both individual security and portfolio levels, to guide both investments and ALM decisions.

- This metric must also be able to produce KPIs per sector, comparing these to a sector average or range, notably to guide engagement and ALM decisions, in coordination with the NZAOA's Engagement Track, as well as other relevant organisations such as Climate Action 100+.

Technical assumptions

7. Data sources.

- Reported data must be favored over inferred (proxy-based) data, in particular where it is robust (eg audited, publicly reported), even though it is understood that a significant amount of GHG emissions measurement are estimates.
- Proxies may be used to cover lack of data provided these are transparent, and based on robust and dynamic (revised regularly) extrapolation rules.
- Companies / emitters should be able to view their own data (GHG emissions, Capex, etc) and approve or correct it if necessary. When such corrections are made, they must be identifiable by data users.

8. Sector biases.

- The methodology may look at companies based on sector specific analysis (using market-based sector classifications) or by comparing companies globally based on aggregate emission levels.
- Sector specific analysis could help investors select best-in-class companies while aggregate emissions analysis could inform wider investment strategies, promoting a deviation away from certain “high temperature” sectors altogether.
- Outright divestment assumptions *per se* are not favoured, but may be justified for “outdated” technologies, such as thermal coal, that present no clear value-add towards carbon neutrality.

9. Climate scenarios.

- The use of specific climate scenarios (either individual scenarios or combinations of scenarios representing a given consensus), as well as deviations or exclusion of others, must be explicit regarding socio-economic and technological developments as well as climate policies, especially the underlying energy mix and sensitivity to specific technologies such as CCS.
- The approach should accommodate not only a single scenario but a set/corridor of scenarios to reduce dependency on individual providers' and scenarios' data, assumptions and narratives. In any case, if multiple scenarios are used, their coherence and consistency must be made explicit.
- A special attention is given to 1.5 °C IPCC scenarios with limited/no overshoot and no or limited use of CCS/BECCS: the methodology should notably align with IPCC P1 and P2 scenario carbon reduction suggestions.

- To improve comparability, scenarios can for example be based on and if possible connected to regulatory stress-testing initiatives, where appropriate.
- The underlying scenarios should be regularly reviewed and where new evidence becomes available should be updated to reflect this. Unrealistic or obsolete scenarios must be discarded.
- The approach should be sufficiently flexible to enable sensitivity analysis to be performed by users with respect to key assumptions and data choices. This flexibility should include accommodating not only a single scenario but a set of scenarios to take account of the uncertainty associated with future developments and to reduce dependency on individual models or data providers.

10. Back-testing.

- The methodology should provide at least 5 years of back-testing capability, although it is understood that its forward-looking nature (Principle 1) can make back-testing challenging.
- The methodology should be “neutral” regarding corporate ownership structures (eg mergers) and consolidation across asset classes.

11. Coverage

- The asset classes covered must include at least corporate debt and equity.
- The security coverage must include at least the main listed equity indices.
- Covering other asset classes is valued and encouraged, in particular sovereign debt, Real Estate and Infrastructures. Sovereign debt “modules” must integrate both the 2015 COP21 NDCs and revised 2020 COP26 NDCs. Solutions for other asset classes are encouraged.
- In addition, it must set out clearly how the temperature KPI can be aggregated across investments in different asset classes, sectors and companies for users to assess the overall “portfolio alignment” with the Paris Agreement.
- Methodologies that cover only a small set of carbon intensive sectors will not be considered compatible with the methodological principles, although a variable methodology depth across sectors may be acceptable.

Usability & platform requirements

12. Target-setting & reporting

- Once finalized, the metric must be readily leverageable by investors (and link to sectoral pathways to net-zero by 2050) to monitor progress against their intermediate (TBC) and long term NZAOA targets (at a sectoral level or at least portfolio level) and support annual public reporting from NZAOA members.

13. Transparency, replicability, stability

- The methodology principles must be documented and transparent, meaning the results produced by calculations can be replicated by other investors using the same databases.
- In addition, changes over time to the methodology should be carried out in a controlled manner, should be documented and analysis of change conducted to ensure that period to period changes can be properly interpreted.
- The methodology and/or organization promoting it should make it possible for companies to validate and where appropriate or correct the data or results.

14. Open source

- The NZAOA publicly favors open source platforms, but nonetheless encourages the development of methodologies that may be proposed by commercial enterprises, provided those commercial solutions are in line with the methodology principles described in this document and are documented, transparent and replicable.
- Whether the methodology has been developed by a public or private organization, it should disclose how the methodology, and where appropriate its implementation, is validated. Any potential conflicts of interest should be clearly disclosed.
- More generally it should leverage existing frameworks where applicable, such as the TCFD, SBTi, IIGCC PAII, TPI, PCAF, CDP / Tropic, etc. The methodology should be regularly benchmarked against other methodologies.

15. Pluggability

- The methodology should ideally use underlying databases and classification systems that make it “pluggable” into financial data terminals (notably by using standard financial market identifiers such as ISIN and CUSIP codes) to improve usability and enable as widespread users as possible, beyond NZAOA members in due course. NZAOA members do not expect, however, such “pluggability” from the outset.

16. Communications

- The basic principles of this methodology must be simple to explain to non-specialist audiences, while the full underlying methodology may remain complex.

GOING FORWARD

Some existing tools and methodologies satisfy several of the above requirements, but no initiative currently fulfils enough requirements for Alliance members to converge on an existing solution. Combinations or modifications of existing approaches, as well as entirely new solutions may equally suit the needs of Alliance members, provided they cater to the needs expressed in this document.

However, adequate forward-looking metrics disclosures, encouraged via amended TCFD guidelines, will greatly support the development, and use of Implied Temperature Rise-type metrics. In turn, once sufficiently homogenized, and supported by respective input data on invested assets, these metrics will be better leveraged by investors to set more dynamic climate targets and develop related strategies, thereby accelerating “real-world impact” in terms of climate mitigation.