



Investment
Leadership
Programme

UN-convened Net-Zero
Asset Owner Alliance

Development and Uptake of Net-Zero-Aligned Benchmarks

A call to action for
asset owners and
index providers

November 2022

In partnership with:



Background

The 80 members of the UN-convened Net-Zero Asset Owner Alliance (Alliance), with US\$ 11 trillion in assets under management have committed to transitioning their investment portfolios to net-zero greenhouse gas (GHG) emissions by 2050, consistent with a maximum temperature rise of 1.5°C above pre-industrial levels. The Alliance's Commitment¹ takes into account the best available scientific knowledge including the findings of the IPCC. Alliance members set intermediate targets every five years—in line with Paris Agreement Article 4.9—and report on progress annually.

In order for members to meet their fiduciary duty of managing risks and achieving target returns, the Commitment takes a holistic approach to managing sustainability considerations. The approach incorporates, but is not limited to, action on climate change, and emphasises GHG emissions reduction outcomes in the real economy.

As institutional investors, asset owners steer large portions of their investment portfolios via benchmarks—a critical tool that supports investors in implementing strategic asset allocation and translates investor objectives to asset managers. Thus, for investors committed to net zero, benchmarks are efficient and practical tools for integrating decarbonisation objectives into the investment process and for supporting net-zero portfolio alignment.

To date, the focus of index providers has been on equity climate benchmarks, while indices in other relevant assets classes—such as fixed income—have been lagging. The purpose of this paper is to, first, provide the basis and context for a discussion on best practices for constructing net-zero-aligned benchmarks and index universes by setting out ten key principles. Second, this paper calls on index providers to consider the outlined principles in the development and enhancement of net-zero-aligned benchmarks and index universes. Third, the paper presents a call to asset owners to apply net-zero-aligned benchmarks.

1 The Net-Zero Asset Owner Alliance Commitment (revised in April 2022): [unepfi.org/wordpress/wp-content/uploads/2022/07/AOA-COMMITMENT-DOC-2022.pdf](https://www.unepfi.org/wordpress/wp-content/uploads/2022/07/AOA-COMMITMENT-DOC-2022.pdf)

Introduction

The European Union's Technical Expert Group on Sustainable Finance has created guidelines for climate benchmarks that were consequently adopted by the European Commission in 2020 as a technical regulation. These climate benchmarks are a positive development that the Alliance used as a starting point for this paper. However, the Alliance believes these benchmarks have some shortcomings, which are discussed and addressed through the Alliance's ten guiding principles.

The guidelines cover two types of climate benchmarks: Paris-Aligned Benchmark (EU PAB) and Climate transition Benchmark (EU CTB).² These benchmark frameworks have been constructed with the aim of informing investors how they can achieve net-zero emissions by 2050 at portfolio level.

While the EU Climate Benchmarks are a welcome and important addition to the index universe, asset owners typically have diverse investment strategies. Specifically, asset owners may require additional customisation to what is currently offered by index providers for the following reasons:

- An asset owner could be managing policyholder assets, where the policyholder expects to receive returns of a broad traditional-market index.
- The EU Climate Benchmarks may have a large tracking error (in comparison to that index), which may or may not grow over time.
- In general, members of schemes or mandates have differing investment time horizons, risk/returns expectations, and/or decarbonisation targets.

Using EU Climate Benchmarks would deliver emissions reductions in the cases of new products, or when the sponsor is less concerned with performance volatility and complete exclusions of high-emitting sectors. Outside of aforementioned cases—when investors may not be able to use the EU Climate Benchmarks—they should consider using net-zero-aligned benchmarks, to ensure they are guided by principles that are important to them. The Alliance sets out ten key principles for net-zero-aligned benchmarks in the remainder of this paper.

2 The guidelines developed by the European Union's Technical Expert Group on Sustainable are accessible here: ec.europa.eu/info/sites/default/files/business_economy_euro/banking_and_finance/documents/190930-sustainable-finance-teg-final-report-climate-benchmarks-and-disclosures_en.pdf



Principles for net-zero-aligned benchmarks and for index universes

For asset owners, it would be beneficial to access benchmarks and established index universes with decarbonisation pathway objectives that can be applied in a broad range of cases and to a globally diversified multi-asset class portfolio. When developing such indices, the following ten key principles should be considered:

1. Ensure transparency in methodology and design

For example, it should be possible to easily understand how the weightings are calculated. Benchmarks should be assessed annually to ensure they remain credible, relevant and appropriate.

2. Starting point of decarbonisation should be set to “today”

Some Climate Benchmarks lead to de facto baseline exclusions of hard-to-abate sectors because they assume that decarbonisation started in the past (minimum reduction of carbon intensity by -30% for the CTB and -50% for PAB, compared to investable universe). However, when new indices are created, the decarbonisation start date should be determined by the asset owner.

3. No mechanical exclusion of high emitting sectors (except thermal coal) or countries

Exclusions of high emitting sectors or constituents are not necessary to achieve decarbonisation objectives. Rather, benchmarks should tilt the weights in favour of the decarbonisation leaders.

- The ‘no exclusions’ approach may lead to smaller decarbonisation advances at the onset. However, the delay would then be compensated by a steeper year-on-year decarbonisation pathway.
- The CA100+ benchmarks may provide further guidance on identifying climate leaders and laggards.

4. Net-zero-aligned indices should correspond to real-economy decarbonisation

This can be achieved by assessing whether companies' short-term and mid-term transition plans align to 1.5°C pathways. Decarbonisation should be credible and aligned with science-based no or limited overshoot 1.5°C sector pathways (eg. IEA 1.5°C or OECM),³ to ensure positive real-world outcomes.

5. Account for difference in speed of decarbonisation across sectors and geographies

Rather than assuming a uniform decarbonisation percentage—for example 7%—which may be punitive or lax depending on the sector and geography, net-zero benchmarks should consider differences in decarbonisation pace (just as the IEA 1.5°C and OECM sector models do). Therefore, fossil fuel phase out should be in line with the relevant scenarios.

6. Ensure that forward-looking indicators are a key input in the decarbonisation process

Forward looking indicators, such as those stated in Climate Action 100+'s Net Zero Company Benchmark or any other framework based on company transition plans should include information on whether issuers are:

- committed to achieving net-zero carbon emissions by 2050,
- pursuing serious short/medium term absolute and intensity decarbonisation targets,
- allocating capital dedicated to decarbonisation projects,
- reporting in accordance with recommendations of the Task Force on Climate-related Financial Disclosures,
- verified by the Science Based Targets initiative,
- developing a strategy on phasing out fossil fuels, etc.

7. Every index universe needs to report on climate key performance indicators (KPIs)

To enable respective reporting and further customisation, climate KPIs, such as carbon intensities, carbon footprint, availability of transition plans, need to be included at constituent level.

These principles should be included as part of every standard index universe without requiring ad-hoc customisations from providers. Asset owners should then be able to easily customise standard indices as needed (e.g. exclude certain issuers, select specific maturities or ratings, exclude subordinated debt, etc.). Reporting should ideally be done in line with global or national standards, for example the EU's Sustainable Finance Disclosure Regulations as well as the EU Taxonomy.

³ Models providing granular sectoral pathways: OECM: unepfi.org/industries/investment/one-earth-climate-model-sectoral-pathways-to-net-zero-emissions/; IEA NZ2050: [iea.org/reports/net-zero-by-2050](https://www.iea.org/reports/net-zero-by-2050)

8. Lack of data must be correctly addressed

- Issuers should report on carbon emissions in bond prospectus, so that index providers can integrate this information into an index universe.
- Many index providers apply sector and country averages to issuers that do not provide their data. This creates a loophole whereby ‘non-aligned’ issuers can improve their standing by not providing the data or issue securities out of new entities where data is not available. A penalising mechanism for those issuers that fail to provide their data should become a standard (especially for companies operating in developed markets). Flexibility should be extended to issuers in emerging markets, who may fail to report their data due to a lack of either ability or supporting environment to report.
- Robust mechanisms ought to be developed to map where subsidiaries’ or financing vehicles’ actual parent risk lies. This is particularly acute when looking at ESG ratings—controversial issuers are very unlikely to pay for (or might even disincentivise) ESG rating agencies to rate their new issuance.

9. Key metrics should be comparable to the parent index and tracking should be practical

To ensure a broad implementation, key metrics such as turnover, credit rating, duration should be comparable to the parent index. Moreover, tracking should be practical and adapted for application by asset owners.

- It remains impossible to put specific numbers on the right level of tracking error or reduced emissions as these will vary in different geographic areas depending on the construction of the underlying index.
- To have a decarbonisation target implies that the tracking error may be increasingly volatile over time.

10. The benchmark universes should incorporate metrics for a just transition, acknowledging that appropriate metrics are still to be refined.⁴

- Climate KPIs should include multiple factors directly tied to inclusive climate finance, such as equitable employment in the climate economy; equity access to affordable clean energy; decarbonisation pathways that reduce inequalities; and inclusive investment in climate-resilient infrastructure and technology.
- The indices should seek to quantify potential and actual negative externalities associated with decarbonisation approaches (including negative impacts on marginalised communities) and incorporate them into climate KPI factors and calculations.

4 A selection of relevant work on incorporating metrics for a just transition:

- Curran et al. (2022). Making transition plans just: how to embed the just transition into financial sector net-zero plans: lse.ac.uk/granthaminstitute/publication/making-transition-plans-just-how-to-embed-the-just-transition-into-financial-sector-net-zero-plans/
- Principles for Responsible Investment (2018). Climate change and the just transition
- A guide for investor action: unpri.org/download?ac=9452
- World Benchmarking Alliance (2021). Just Transition Assessment: worldbenchmarkingalliance.org/research/2021-just-transition-assessment/



Call to action

The members of the UN-convened Net-Zero Asset Owner Alliance call on Index Providers to provide benchmarks and index universes based on the principles laid out above, so as to support large institutional global investors in aligning their investment portfolios to net zero by 2050.

This is also a call for asset owners to apply net-zero-aligned benchmarks as an effective tool for investment portfolio alignment to net zero.



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