



# EVOLUTIONS IN CLIMATE CHANGE INVESTING: EU CLIMATE BENCHMARKS

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**New EU climate benchmarks have spearheaded the development of flexible portfolio allocation tools that help investors transform their portfolio into an instrument for addressing climate change. This paper covers the new class of benchmarks and what they mean for investors.**

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Climate change; unsustainable urban growth; and air, water and land pollution all represent existential threats not only to global populations and societies, but also to businesses. While the physical risks that climate change poses to businesses are those that threaten all of us, there are many transitional risks to which certain companies will be less resilient. Transitional risks imply structural changes arising from policy changes and shifts in market preferences, norms and technology. This can be reflected in increased costs such as emissions legislation that results in carbon taxes, having to invest in new lower-emission technologies and raw materials, or declining consumer demand due to reputational risk, or products or services becoming redundant or obsolete.

But the transition to a low carbon economy also presents many new opportunities to innovate and streamline efficiencies. Organisations that innovate and develop new low-emission products and services may improve their competitive position and capitalise on shifting consumer and producer preferences. For example, many new investment opportunities exist around the future of energy as emerging technologies and AI software are improving and more closely linking energy generation, energy storage and energy usage. Furthermore, businesses which harness these technological advances are shifting their energy usage toward low emission energy sources and driving energy efficiency in order to save on energy costs. Increasingly investors are calling for companies to therefore set out their climate strategy to best capture these opportunities.

Despite the evolving opportunities to transition to a more sustainable future, drastic steps still need to be taken to formally address climate change. In 2015, a collective commitment by the world's governments to combat climate change led to the United Nations' Paris Agreement to pursue preventing global temperature rise. The Paris Agreement provides an ambitious roadmap; if commitments, policies and action can deliver a 7% greenhouse gas (GHG) emissions reduction every year between 2020 and 2030, global warming can be limited to 1.5C, preventing the most catastrophic effects of climate change. To reach these energy and climate goals by 2030, around

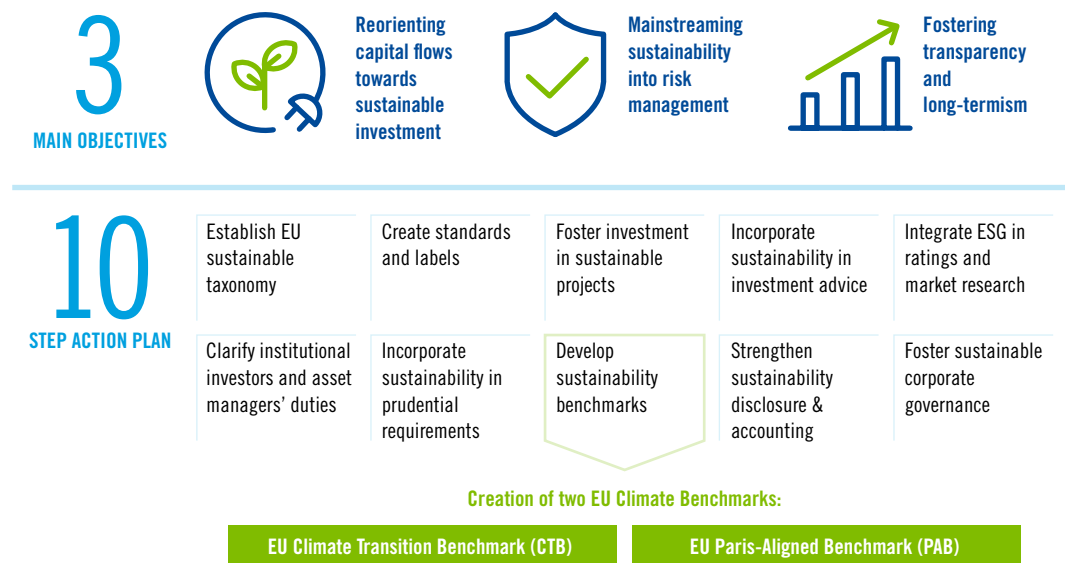


€180bn in additional yearly funding will be needed.<sup>1</sup> Policymakers, financial institutions, businesses and investors share a collective responsibility in driving these efforts.

## THE EUROPEAN UNION'S (EU'S) ACTION PLAN

Through the EU Action Plan for Sustainable Finance, the European Commission (EC) has sought to hardwire sustainability considerations into the financial system, and is seeking to channel public and private capital towards investments to meet the decarbonisation targets. As part of the Action Plan, the EC established the Technical Expert Group (TEG) on sustainable finance in 2018 to advise on the objectives and steps needed. As detailed below, one of the steps was to develop sustainability benchmarks to promote Paris-aligned investments. The TEG set out minimum standards on two types of climate benchmarks that aim to provide clear rules that ensure the indexes are comparable and transparent: the EU Climate Transition Benchmark (EU CTB) and the EU Paris-Aligned Benchmark (EU PAB).

### EXHIBIT 1: THE EU ACTION PLAN FOR SUSTAINABLE FINANCE



Source: European Commission: Action plan on financing sustainable growth (2018).

The EU climate benchmarks seek to:

- Increase transparency on investors' impact, specifically with climate change and energy transition.
- Allow comparability between climate benchmarks while leaving benchmark administrators with flexibility in their methodologies.
- Reduce the risk of greenwashing through common standards, objectives and quantitative metrics.

## A NEW CLASS OF BENCHMARKS TACKLING CLIMATE CHANGE

Before the development of these new benchmarks, low-carbon index construction has focused on two principle approaches. One is “exclusions”-driven, namely identifying and removing those companies using fossil fuels, and the other is “carbon-tilted,” with index weights adjusted positively toward companies demonstrating reduced emissions.

### Science-Based Targets

The Science-Based Targets initiative champions science-based target setting as a powerful way of boosting companies' competitive advantage in the transition to the low-carbon economy. It is a collaboration between CDP, the United Nations Global Compact (UNGC), World Resources Institute (WRI), the World Wide Fund for Nature (WWF) and one of the We Mean Business Coalition commitments.

Targets adopted by companies to reduce GHG emissions are considered “science-based” if they are in line with what the latest climate science says is necessary to meet the goals of the Paris Agreement.

The new climate benchmarks leverage the rapidly growing pool of available data and analytics, assessing how aligned each underlying company is to a 1.5 or 2C global warming scenario. Not only do they aim to hedge against climate transition risks (backward looking), but also to capture opportunities (forward looking). Research includes independently assessed science-based targets, CO2 emissions, and forward-looking product, strategy, emissions and policy plans.

As seen in Exhibit 2 below, while both climate benchmarks meet the minimum standards set out by the TEG, the PAB is the more stringent of the two. Compared to EU CTB, the EU PAB:

- Calls for a higher level of decarbonization versus the underlying investable universe.
- Has additional exclusions based on activities that lead to high GHG emissions. Companies which are currently excluded from the index due to a high reliance on fossil fuels, should they transition their energy mix, could in the future be eligible to join the index.

### EXHIBIT 2: EU CLIMATE BENCHMARK MINIMUM STANDARDS

	EU Climate Transition Benchmark (CTB)	EU Paris-Aligned Benchmark (PAB)
<b>Risk-oriented minimum standards</b>		
<b>Help reduce exposure to climate-related financial risks including stranded asset, transition &amp; physical risks</b>	<b>Carbon Intensity Reduction</b> Significant reduction in total GHG emission intensity compared to the investable universe  Scope 1+2 (+3) emissions	30% decarbonization vs benchmark
	<b>Scope 3 Phase-In</b>	Up to a four-year timeframe to account for all direct and indirect emissions
	<b>Baseline Exclusions</b>	Controversial weapons; Societal norms violators; Violators of UN Global Compact Principles; Tobacco
	<b>Activity Exclusions</b>	No
		Coal (1%+ revenues); Oil (10%+ revenues); Natural gas (50%+ revenues); Electricity producers with carbon intensity of lifecycle
<b>Opportunity-oriented minimum standards</b>		
<b>Help direct capital to those companies leading the transition to a low-carbon economy</b>	<b>Self-Decarbonization</b> Year-on-year self-decarbonization of the benchmark	At least 7% per annum; in line with or beyond the decarbonization trajectory from the IPCC's 1.5C scenario
	<b>Exposure Constraints</b>	Minimum exposure to sectors highly exposed to climate change issues is at least equal to market benchmark value
	<b>Corporate Target Setting</b>	Weight increase shall be considered for companies which set evidence-based targets under strict conditions to avoid greenwashing

Source: European Commission: Sustainable Finance—Minimum Standards for Climate Benchmarks.

## PARIS-ALIGNED INDEXES: FLEXIBLE PORTFOLIO CONSTRUCTION TOOLS FOR ADDRESSING CLIMATE CHANGE

With the PAB being more stringent than the CTB, several leading index providers have built indexes based off these standards, serving as a benchmarking tool for those looking to be at the forefront of climate transition investing.

As an early entrant into the Paris-aligned space, Franklin Templeton has launched two passive Undertakings for the Collective Investment in Transferable Securities (UCITS) exchange-traded funds (ETFs) that are fully compliant with the PAB. The S&P 500 Paris-Aligned Climate Index and the STOXX Europe 600 Paris-Aligned Benchmark Index were selected as the underlying benchmarks.<sup>2</sup>

While not the only providers to build PAB indexes, S&P and STOXX were selected by Franklin because their Paris-aligned versions aim to remain as close as possible to the parent indexes. This enables investors to retain the broad, diversified exposure benefits of these markets while aligning with the climate goals of the Paris Agreement. Moreover, unlike other index providers who generally rely on in-house research capabilities, S&P and STOXX have partnered with leading carbon data specialists—Trucost and ISS, respectively—enabling them to build methodologies that integrate state-of-the-art data sets and analysis. As a result, these Paris-aligned indexes have ambitious carbon reduction targets, as well as meaningful broader environmental, social and governance (ESG) components.

### WHAT DOES THIS MEAN FOR INVESTORS?

Franklin Templeton's new Paris-aligned UCITS ETFs exemplify how the new EU climate benchmarks have spearheaded the development of flexible portfolio allocation tools that help investors transform their portfolio into an instrument for addressing climate change. We believe that as investors seek to decarbonise portfolios and actively measure and manage climate risk in line with their investment liabilities, that they will seek proactive climate solutions. With the diversified structure of these funds, investors can move away from the notion that these are niche products and instead use them in a variety of ways.

#### EXHIBIT 3: PORTFOLIO USES



A core sustainable equity allocation aligned to the low-carbon transition



A low-carbon allocation within a broader ESG Fund of Funds



A satellite exposure to help reduce climate change risks and access opportunities to low-carbon transition

Flows into sustainable ETFs more than doubled in 2019 and global ESG ETF assets are \$88bn worldwide.<sup>3</sup> We believe this momentum is likely to continue through a combination of changing investor preferences and regulation. European and Asian regulators increasingly seek demonstrable evidence of ESG integration and management of climate risk, while investor demand for sustainable investments looks set to continue its strong growth trajectory, across many investor types, from millennials and private wealth, through to insurance schemes.

## Endnotes

1. Source: European Commission. Financing Sustainable Growth, 2019.
2. Indexes are unmanaged and one cannot directly invest in them. They do not include fees, expenses or sales charges.
3. Source: ETFGI, 30 June 2020.

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