Insights

Environmental, Social & Governance (ESG)

January 2020

EU Climate Benchmarks: A Guide

The European Union's 'Action Plan on Financing Sustainable Growth' has published into law two new categories of climate benchmarks and ESG disclosures for benchmarks. What are the implications for investors?

Background

As part of the EU effort to transition to a sustainable economy , the European Commission published an 'Action Plan on Financing Sustainable Growth' in May 2018 with the aim to integrate sustainability risks, opportunities and targets into the European regulatory framework and to mobilise investment towards sustainable growth.

The Action Plan outlines a number of legislative initiatives, the first package of which includes an EU classification system/Taxonomy to determine whether an economic activity is sustainable, disclosure requirements for a range of financial market participants and new measures regarding investment benchmarks. The Commission set up a Technical Expert Group on Sustainable Finance (TEG) to assist in developing some of these initiatives.

This guide focusses on the introduction of two new categories of climate benchmarks and associated ESG disclosures applicable to all benchmarks. The new climate benchmarks provide for a harmonised, reliable tool to pursue low-carbon investment strategies by establishing a new category of financial benchmarks.

Benchmark administrators must comply with the new requirements by 30 April 2020. The new requirements will be incorporated into the EU Benchmarks Regulation, which is separately under review by the Commission and will likely result in strengthened supervision and governance of climate benchmark administrators.

What's New?

EU Climate Benchmarks

A climate benchmark is defined as an investment benchmark that incorporates specific objectives related to greenhouse gas (GHG) emission reductions and the transition to a low-carbon economy — based on the scientific evidence of the IPCC — through the selection and weighting of underlying constituents.

There are two new benchmarks:

- **EU Climate Transition Benchmark (EU CTB)**
- **EU Paris-Aligned Benchmark (EU PAB)**

Both benchmarks have the same criteria focussed on decarbonisation, but the thresholds are different. The second benchmark is aligned to the Paris Agreement goal to limit the increase in global average temperatures to well below 2°C above pre-industrial levels.

Compared to EU CTBs, EU PABs:

- Allow for a higher decarbonisation of the investment relative to the underlying investable universe (50% compared to 30%).
- Have additional activity exclusions on fossil fuels and electricity producers with high GHG emissions.
- Have a stronger focus on opportunities with a significantly enhanced green share/brown share ratio.

A full list of the minimum benchmark standards is in Appendix A.

The EU CTBs are suitable for institutional investors such as pension funds and (re)insurance companies, whose objective is to protect assets against investment risks related to climate change and the transition to a low-carbon economy.

The EU PABs are designed for institutional investors that want to be at the forefront of the immediate transition towards a +1.5°C scenario.

Historically, benchmarks incorporating constraints or objectives related to GHG emissions have lacked consistency and not been tailored to investor needs and constraints. They have also primarily been built around reducing tail risks, for example, that arising from investing in companies exposed to severe weather phenomena.

In contrast, investors using the new EU CTBs and EU PABs can, at a portfolio level:

- Hedge against a wider array of climate transition risks:
  - **Policy and Legal Risk** For example, risks related to changes in the regulatory framework, like carbon pricing mechanisms or those related to litigation claims.
  - **Technology Risk** Impact of technological advancement in the transition to a low-carbon economy.
  - **Market Risk** Changes in supply and demand for goods and services.
  - **Reputation Risk** Arising, for example, through name and shame campaigns or corporate incidents (e.g. BP and Volkswagen).
- Direct investments towards opportunities in the energy transition. These broadly include products and services related to renewable energy and energy efficiency.

Benchmark Disclosure Requirements

The new regulation stipulates that an index administrator must deliver "an explanation of how the key elements of the methodology…reflect ESG factors for each benchmark or family of benchmarks, with the exception of currency and interest rate benchmarks".

The table in Appendix B summarises the minimum ESG disclosure requirements by asset class for inclusion in the benchmark methodology and the benchmark statement.

There are additional disclosures regarding the alignment of the new benchmarks to the Paris Agreement. By 31 December 2021, all benchmarks or families of benchmarks, except currency and interest rate benchmarks, should make publicly available how their methodology aligns with the target of carbon emission reduction or attains the long-term global warming target of the Paris Climate Agreement. All benchmark administrators should also "endeavour" to market one or more climate benchmarks from this date.

These disclosures are summarised in Appendix C.

Next Steps

In December 2019, the European Commission amended the EU Benchmarks Regulation to introduce the new categories of climate benchmarks. Benchmark administrators will be required to comply with the new provisions from **30 April 2020.**

In parallel, the TEG has published a final report in September 2019 with recommendations on minimum standards in order to harmonise the underlying methodologies of the new categories of climate benchmarks, and essentially, to prevent so-called greenwashing. Those recommendations also cover the associated disclosures for benchmark administrators.

As such, the Commission will now consider the work of the TEG and produce Delegated Acts that specify the minimum content of the disclosure obligations that administrators of EU CTBs and EU PABs should be subject to, and to specify the minimum standards for harmonisation of the methodology, including the method for the calculation of the carbon emissions associated with the underlying assets. The Delegated Acts are expected to enter into force in the first quarter of 2020.

What Are the Implications For Investors?

The benchmarks provide a robust and consistent framework for institutional investors to implement their views on climate risk mitigation and climate-related opportunities across asset classes within their portfolios. The benchmarks and the disclosures around them are predicated on the Paris Agreement framework to limit the global increase in temperatures to below 2°C (ideally below 1.5°C by the end of the century). As such, we hope they will help to further mobilise investor capital towards limiting climate change.

Through introducing standard, objective and quantitative metrics on benchmark composition and disclosure, the benchmarks and disclosures should help to reduce the incidence of greenwashing, where institutions claim to be more environmentally sustainable than they are.

Investors can use the new climate benchmarks in different ways. They can serve as an underlying for passive investment strategies, or as an investment performance benchmark for GHG emission-related strategies.

While these are welcome developments, the adoption of the benchmarks may face bumps in the road which delay adoption. With regards to scope of implemented climate data, the EU CTBs and EU PABs set a new standard, so moving to the new framework will likely result in some disruption. For investors without any form of climate risk management currently, this will be even greater.

Furthermore, the objective to meet the new climate benchmark requirements while also abiding by investment policy statements will likely make portfolio construction and investment strategy more complicated. For example, in order to meet the EU CTB requirement of cutting carbon emissions by 30%, and annual self-decarbonisation of 7%, while adhering to diversification and risk-adjusted return characteristics requires fairly sophisticated models. This is even more true for the EU PABs. Index investors, in particular, will have to weigh the benefits of incorporating climate data — and the associated complexities — with managing portfolio tracking error within limits.

These challenges will require investment in employee and system resources to analyse, monitor and report on portfolio characteristic, as well as greater governance and oversight.

Finally, some uncertainty exists regarding how investors should measure progress on green share and brown share investments given a lack of consistent definitions and measures. This may be addressed in the TEG's ongoing work on developing a taxonomy of sustainable activities.

Appendix A

Minimum Benchmark Standards

Minimum Standards	EU CTB	EU PAB
Risk Oriented		
Minimum Scope 1 + 2 (+3)[1] carbon intensity reduction compared to investable universe	30%	50%
Scope 3 phase-in	Up to 4 years	Up to 4 years
Baseline Exclusions	Line 1: Yes Line 2: Controversial Weapons Line 3: Societal Norms Violaters[2]	Line 1: Yes Line 2: Controversial Weapons Line 3: Societal Norms Violaters
Activity Exclusion	No	Coal (1% + revenues) Oil (10% revenues) Natural Gas (50% revenues) Electricity producers with carbon intensity of lifecycle GHG emissions higher than 100g CO_2e/kWh (50%+ revenues)
Opportunity Oriented		
Year-on-year self-decarbonisation of the benchmark	At least 7% on average per annum: in lline with or beyond decarbonisation trajectory from the IPCC's 1.5°C scenario (with no or limited overshoot)	
Minimum green share/brown share ratio compared to investable universe (Voluntary)	At least equivalent	Significantly larger (factor 4)
Exposure Constraints	Minimum exposure to sectors highly exposed to climate change issues is at least equal to equity market benchmark value	
Corporate Target Setting	Weight increase shall be considered for companies which set evidence-based targets under strict conditions to avoid greenwashing (see Article 9 in section 5.12 re conditions)	
Disqualification from label if 2 consecutive years of misalignments with trajectory	Immediate	Immediate
Relevance Oriented		
Review Frequency	Minimum requirements shall be reviewed every three years to recognise market development as well as technological and methodological progress	

1 Scope 3 being phased-in during a four-year timeframe.
2 Societal norms include UNGC Principles, OECD Guidelines for Multinational Enterprises and the 6 Environmental Objectives: 1) climate change mitigation; 2) Climate Chnage adaptation; 3) Sustainable use and protection of water and marine resources; 4) Transition to a circular economy, waste prevention and recycling; 5) Pollution prevention and control; 6) Protection of healthy ecosystems.

Appendix B

ESG Factors to be Disclosed by Asset Class

	ESG Disclosure Factors	Main Asset Classes			Other Asset Classes		
		Equities	Fixed Income & Corporates and Securitised (ABS)	Fixed Income — SSA[1]	Hedge Funds	Commodities	Private Equity Private Debt Infrastructure
Overall ESG Disclosure	Consolidated ESG Rating[2]	Yes	Yes	Yes	Yes	No	No
	ESG Ratings Top Ten Constituents	Yes	Yes	Yes	No	No	No
	UNGC Violations %	Yes	Yes	Yes	Yes	No	Yes
	International Standards Signatories %	No	No	Yes	No	No	No
Environmental Disclosure	Consolidated Environmental Rating[2]	Yes	Yes	Yes	Yes	No	Yes
	Carbon intensity	Yes	Yes	No	No	No	Yes
	Fossil Fuel Sector Exposure %	Yes	Yes	No	No	No	Yes
	Green Revenues % or Green Capex %	Yes	Yes	Yes	No	No	Yes
	Green Bonds %	No	Yes	Yes	No	No	No
	Exposure Climage-Related Physical Risks	Yes	Yes	Yes	No	Yes	No
	Exposure Climate-Related Physical Risks Methodology	Yes	Yes	Yes	No	Yes	No
Social Disclosure	Consolidated Social Rating[2]	Yes	Yes	No	Yes	No	No
	Social Violations	Yes	Yes	No	No	Yes	Yes
	Controversial Weapons %	Yes	Yes	No	Yes	No	Yes
	Controversial Weapons Definition	Yes	Yes	No	Yes	No	Yes
	Tobacco%	Yes	Yes	No	No	No	Yes
	Tobacco Definition	Yes	Yes	No	No	No	Yes
	Human Rights Index	No	No	Yes	No	Yes	No
	Income Inequality	No	No	Yes	No	No	No
	Freedom of Expression	No	No	Yes	No	No	No
Governance Disclosure	Consolidated Governance Rating[2]	Yes	Yes	Yes	No	No	No
	Board Independence %	Yes	No	No	No	No	No
	Board Diversity %	Yes	No	No	No	No	No
	Corruption	No	No	Yes	No	Yes	No
	Political Stability	No	No	Yes	No	Yes	No
	Rule of Law	No	No	Yes	No	Yes	No
	Stewardship Policies	No	No	No	Yes	No	No

1 Included are Supranational, Sovereigns, Government agencies, Municipals, Money Market
2 For all ratings, include 1) Rating Provider, 2) Rating Value, 3) Coverage % and 4) Visual of the Rating Distribution
Weighted Average: For all disclosure factors, the reporting required is weighted average at the index

Appendix C

Disclosures Associated with EU CTB and EU PAB

Mandatory Disclosure Requirements

EU CTB & EU PAB	All criteria and methods, including selection and weighting factors, metrics and proxies used in the benchmark methodology
EU CTB & EU PAB	The exclusion criteria based on climate-related or other ESG considerations
EU CTB & EU PAB	Carbon intensity of the index (scope 1+2+3 phased in);
EU CTB & EU PAB	Disclosure of Year-on-Year decarbonisation trajectory, base year for calculation and achieved GHG emissions trajectory of the benchmark since creation
EU CTB & EU PAB	The degree to which the IPCC decarbonisation trajectory (1.5 degrees C with no or limited overshoot) has been achieved on average per year since creation
EU CTB & EU PAB	The type and source of data used to determine the decarbonisation trajectory, including: (i) Scope 1 emissions. (ii) Scope 2 emmissions, (iii) Scope 3 emissions, in particular for sectors with high impact on
EU CTB & EU PAB	Required disclosures based on Annex III of Regulation amending Regulation (EU) 2016/1011
	Climate change and its mitigation, (iv) whether the data uses the EU Product and Organisation Environmental Footprint methods, or, global standards such as TCFD
EU CTB & EU PAB	Qualitative Comment on Climate Tail Risks (i.e. downside deviations from the expectation with particular focus on tail risks)
EU CTB & EU PAB	Measure of overlap between the EU CTB and its investable universe (asset-level calculated active share)

Voluntary Disclosure Requirements

EU PAB	Measure of overlap between the EU CTB and its investable universe (asset-level calculated active share)	Benchmark statement — ESG disclosure template

About State Street Global Advisors

For four decades, State Street Global Advisors has served the world's governments, institutions and financial advisors. With a rigorous, risk-aware approach built on research, analysis and market-tested experience, we build from a breadth of active and index strategies to create cost-effective solutions. As stewards, we help portfolio companies see that what is fair for people and sustainable for the planet can deliver long-term performance. And, as pioneers in index, ETF, and ESG investing, we are always inventing new ways to invest. As a result, we have become the world's third-largest asset manager with US $2.95 trillion* under our care.

* AUM reflects approximately $43.96 billion USD (as of September 30, 2019), with respect to which State Street Global Advisors Funds Distributors, LLC (SSGA FD) serves as marketing agent; SSGA FD and State Street Global Advisors are affiliated.

ssga.com

For Investment Professional Use Only.

State Street Global Advisors Worldwide Entities

Abu Dhabi: State Street Global Advisors Limited, Middle East Branch, 42801, 28, Al Khatem Tower, Abu Dhabi Global Market Square, Al Maryah Island, Abu Dhabi, United Arab Emirates. Regulated by ADGM Financial Services Regulatory Authority. T: +971 2 245 9000.
Australia: State Street Global Advisors, Australia, Limited (ABN 42 003 914 225) is the holder of an Australian Financial Services Licence (AFSL Number 238276). Registered office: Level 17, 420 George Street, Sydney, NSW 2000, Australia T: +612 9240-7600. F: +612 9240-7611.
Belgium: State Street Global Advisors Belgium, Chaussée de La Hulpe 120, 1000 Brussels, Belgium. T: 32 2 663 2036, F: 32 2 672 2077. SSGA Belgium is a branch office of State Street Global Advisors Ireland Limited. State Street Global Advisors Ireland Limited, registered in Ireland with company number 145221, authorised and regulated by the Central Bank of Ireland, and whose registered office is at 78 Sir John Rogerson's Quay, Dublin 2.
Canada: State Street Global Advisors, Ltd., 1981 McGill College Avenue, Suite 500 , Montreal, Qc, H3A 3A8, T: +514 282 2400 and 30 Adelaide Street East Suite 800, Toronto, Ontario M5C 3G6. T: +647 775 5900.
Dubai: State Street Global Advisors Limited, DIFC Branch, Central Park Towers, Suite 15-38 (15th floor), P.O Box 26838, Dubai International Financial Centre (DIFC), Dubai, United Arab Emirates. Regulated by the Dubai Financial Services Authority (DFSA). T: +971 (0)4-4372800, F: +971 (0)4-4372818.
France: State Street Global Advisors Ireland Limited, Paris branch is a branch of State Street Global Advisors Ireland Limited, registered in Ireland with company number 145221, authorised and regulated by the Central Bank of Ireland, and whose registered office is at 78 Sir John Rogerson's Quay, Dublin 2. State Street Global Advisors Ireland Limited, Paris Branch, is registered in France with company number RCS Nanterre 832 734 602 and whose office is at Immeuble Défense Plaza, 23-25 rue Delarivière-Lefoullon, 92064 Paris La Défense Cedex, France. T: (+33) 1 44 45 40 00. F: (+33) 1 44 45 41 92.
Germany: State Street Global Advisors GmbH, Brienner Strasse 59, D-80333 Munich. Authorised and regulated by the Bundesanstalt für Finanzdienstleistungsaufsicht ("BaFin"). Registered with the Register of Commerce Munich HRB 121381. T: +49 (0)89-55878-400. F: +49 (0)89-55878-440.
Hong Kong: State Street Global Advisors Asia Limited, 68/F, Two International Finance Centre, 8 Finance Street, Central, Hong Kong. T: +852 2103-0288. F: +852 2103-0200.
Ireland: State Street Global Advisors Ireland Limited is regulated by the Central Bank of Ireland. Registered office address 78 Sir John Rogerson's Quay, Dublin 2. Registered Number: 145221. T: +353 (0)1 776 3000. F: +353 (0)1 776 3300.
Italy: State Street Global Advisors Ireland Limited, Milan Branch (Sede Secondaria di Milano) is a branch of State Street Global Advisors Ireland Limited, registered in Ireland with company number 145221, authorised and regulated by the Central Bank of Ireland, and whose registered office is at 78 Sir John Rogerson's Quay, Dublin 2. State Street Global Advisors Ireland Limited, Milan Branch (Sede Secondaria di Milano), is registered in Italy with company number 10495250960 - R.E.A. 2535585 and VAT number 10495250960 and whose office is at Via Ferrante Aporti, 10 - 20125 Milano, Italy. T: +39 02 32066 100. F: +39 02 32066 155.
Japan: State Street Global Advisors (Japan) Co., Ltd., Toranomon Hills Mori Tower 25F 1-23-1 Toranomon, Minato-ku, Tokyo 105-6325 Japan. T: +81-3-4530-7380. Financial Instruments Business Operator, Kanto Local Financial Bureau (Kinsho #345), Membership: Japan Investment Advisers Association, The Investment Trust Association, Japan, Japan Securities Dealers' Association.
Netherlands: State Street Global Advisors Netherlands, Apollo Building, 7th floor Herikerbergweg 29 1101 CN Amsterdam, Netherlands. T: 31 20 7181701. SSGA Netherlands is a branch office of State Street Global Advisors Ireland Limited, registered in Ireland with company number 145221, authorised and regulated by the Central Bank of Ireland, and whose registered office is at 78 Sir John Rogerson's Quay, Dublin 2.
Singapore: State Street Global Advisors Singapore Limited, 168, Robinson Road, #33-01 Capital Tower, Singapore 068912 (Company Reg. No: 200002719D, regulated by the Monetary Authority of Singapore). T: +65 6826-7555. F: +65 6826-7501.
Switzerland: State Street Global Advisors AG, Beethovenstr. 19, CH-8027 Zurich. Authorised and regulated by the Eidgenössische Finanzmarktaufsicht ("FINMA"). Registered with the Register of Commerce Zurich CHE-105.078.458. T: +41 (0)44 245 70 00. F: +41 (0)44 245 70 16.
United Kingdom: State Street Global Advisors Limited. Authorised and regulated by the Financial Conduct Authority. Registered in England. Registered No. 2509928. VAT No. 5776591 81. Registered office: 20 Churchill Place, Canary Wharf, London, E14 5HJ. T: 020 3395 6000. F: 020 3395 6350.
United States: State Street Global Advisors, One Iron Street, Boston, MA 02210-1641.