‘SCIENCE-BASED TARGETS’ FOR FINANCIAL INSTITUTIONS

Position Deck + Consultation

Feb 2020

Disclaimer

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The document includes an interpretation of the regulation in Europe and the US based on the regulations and the interpretative guidance, and an analysis of certain claims based on our interpretation of this guidance. This analysis does not constitute a review of legal risks in specific jurisdictions. 2°ii does not make any representation of the potential legal risks faced by specific claims or financial institutions.

The document presents a technical analysis of the draft criteria proposed by the SBTi consortium, based on our knowledge on Feb 11, 2020. The information and opinions constitute a judgment as at the date indicated and are subject to change. The organization is not responsible for any use that may be made of the information it contains.

Context: 2Dii and the SBT Initiative

In February 2020, the Science-Based Targets Initiative for Financial Institutions released its "*SBT-Finance Target Validation Draft Criteria for Stakeholder Advisory Group Consultation*".

The document suggest three 'methods' to calculate an indicator that can be used as a basis for target setting: the Sector Decarbonization Approach (SDA), the Paris Agreement Capital Transition Assessment (PACTA*) and the SBT Portfolio coverage (engagement with 30% of the investees on SBTs).

The document also outlines a set of preliminary criteria as to what qualifies as a science-based target.

*Initiated and managed by 2Dii

In 2018, WRI, WWF and CDP invited the 2° Investing Initiative (2Dii) to take part in the development of the Science-Based Targets Initiative for Financial Institutions as methodology co-developer with the consultancy Navigant.

After 18 months of collaboration, 2Dii has decided to withdraw from the project due to the inability to agree with the partners on the fundamental principles governing the methodological development and notably the definition of financial institutions' 'impact'.

This deck presents 2Dii's reasoning behind the decision and the organization's current position on setting science-based targets and measuring the climate impact of financial institutions. It is designed to advise our stakeholders on our conclusions and understanding and solicit feedback to inform our position moving forward.

Although our conclusions are, in our view, clear and documented, we appreciate that methodological development is an ongoing trial and error process. The intent of this document is to open a technical debate in the community of practice and the policymaking space.

This document is therefore designed to consult our stakeholders on our reasoning to inform next steps.

Each key finding or conclusion is associated with a question, that can be answered via an online questionnaire.

The results will be circulated with our final paper on the topic (by Q2 2020).

Open the survey while you go through these slides and respond to the questions directly in the survey

ESTIMATED TIME TO COMPLETE

13

Minutes

https://www.surveymonkey.de/r/SBtargets

2Dii reasoning on ‘science-based’ target setting for financial institutions

+ questions about your views

What is the purpose of setting science-based targets?

Contribute to reducing GHG emissions in the real economy

SCIENCE BASED TARGETS

DRIVING AMBITIOUS CORPORATE CLIMATE ACTION

- The tagline of SBTi is *"Driving ambitious corporate climate actions" and refers to target setters as companies "**taking action**"*
- The website specifies that *"Targets adopted by companies **to reduce greenhouse gas (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".*

Conclusion #1

The validation of a 'Science-Based' target by the SBTi consortium communicates to the general public that the target-setting company has decided to reduce GHG emissions in the real economy by a certain amount (quantified) that is considered sufficient to meet climate targets

Do you disagree with this conclusion?

What is the stated objective of potential target setters?

Contribute to reducing GHG emissions in the real economy

Net zero Asset Owners Alliance
(12 investors, $4Tn AuM)
"The members of the Alliance commit to transitioning their investment portfolios to net-zero GHG emissions by 2050 consistent with a maximum temperature rise of 1.5°C above pre-industrial temperatures, taking into account the best available scientific knowledge including the findings of the IPCC, and regularly reporting on progress, including establishing intermediate targets every five years in line with Paris Agreement Article 4.9."

Collective Commitment to Climate Action (36 banks, $13Tn of assets)
"The Collective Commitment to Climate Action sets out concrete and time-bound actions that banks will take to scale up their contribution to and align their lending with the objectives of the Paris Agreement on Climate, including:

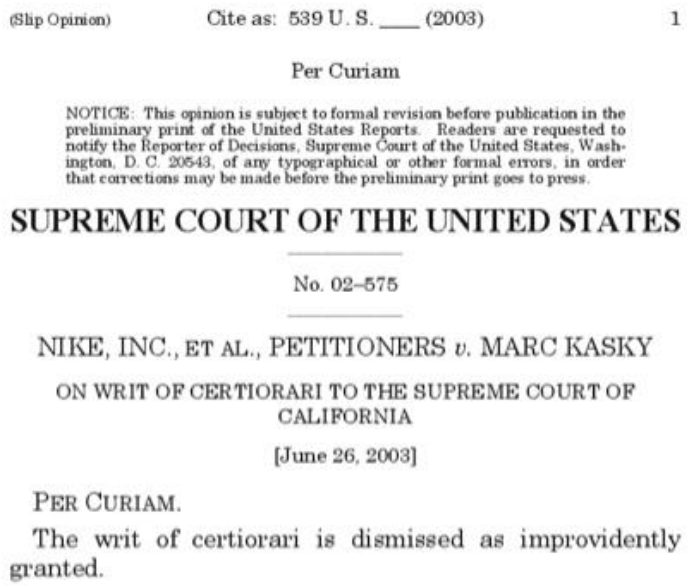
- *aligning their portfolios to reflect and finance the low-carbon, climate-resilient economy required to limit global warming to well-below 2°, striving for 1.5 degrees Celsius;*
- *taking concrete action, within a year of joining, and use their products, services and client relationships to facilitate the economic transition required to achieve climate neutrality;*
- *being publicly accountable for their climate impact and progress on these commitments."*

Conclusion 2
The communication (collective pledges or individual statements) of potential adopters suggests that the objectives of pledges go beyond financial risk management. They aim to contribute to the reduction of GHG emissions in the real economy.

Do you disagree with this conclusion?

What does the regulation say?

Commitments to reduce GHG emission can be considered as environmental marketing claims



(Slip Opinion) Cite as: 539 U. S. ____ (2003) 1

Per Curiam

NOTICE: This opinion is subject to formal revision before publication in the preliminary print of the United States Reports. Readers are requested to notify the Reporter of Decisions, Supreme Court of the United States, Washington, D. C. 20543, of any typographical or other formal errors, in order that corrections may be made before the preliminary print goes to press.

SUPREME COURT OF THE UNITED STATES

No. 02–575

NIKE, INC., ET AL., PETITIONERS *v.* MARC KASKY

ON WRIT OF CERTIORARI TO THE SUPREME COURT OF CALIFORNIA

[June 26, 2003]

PER CURIAM.

The writ of certiorari is dismissed as improvidently granted.

From a legal perspective, there is no ‘safe harbor’ (such as free speech in the US) for corporate commitments related to social and environmental issues. Such communications can potentially be considered as marketing claims under unfair competition laws, especially when they relate to retail investment products.

In the US, the 2003 Nike vs. Kasky case raised, but did not resolve the matter.

Conclusion 3

Financial institutions’ commitments to reduce GHG emission are made publicly (i.e. not behind ‘confirm your professional status’ walls), and in many cases are tied in some form to products and services such as mutual funds, life insurance contracts, or savings accounts – as evidenced by their inclusion in marketing and advertisement material.

Do you disagree with this conclusion?

What does the regulation say?

Environmental claims are regulated: they must be unambiguous and substantiated

In Europe:

- The Unfair commercial practices directive prohibits communications that "*contains false information and is therefore untruthful or in any way, including overall presentation, deceives or is likely to deceive the average consumer, even if the information is factually correct (…)"*
- The EC's guidance on UCPD (2016) specifies that *"traders must present their green claims in a clear, specific, accurate and **unambiguous manner**, to ensure that consumers are not misled (…) must **have the evidence to support their claims"** and **"**claims should be based on robust, independent, verifiable and generally recognized **evidence which takes into account the latest scientific findings and methods."***

Similar consumer protections exist in other jurisdictions (e.g. US) under unfair commercial practices and false advertising laws

Conclusion 4
Environmental marketing claims are regulated in many jurisdictions.
They must be unambiguous and associated with scientific evidence.

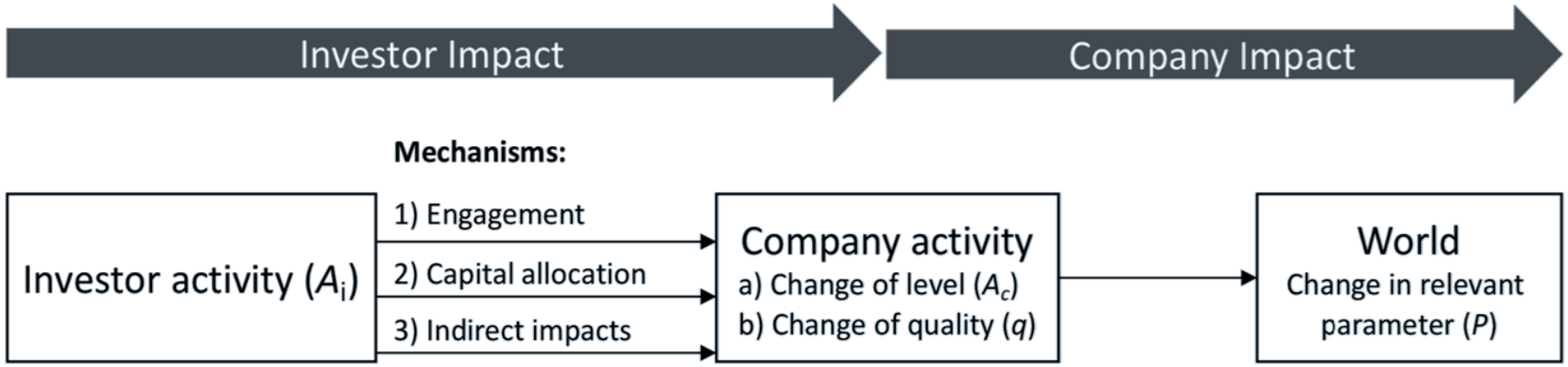
Do you disagree with this conclusion?

Regulatory analysis

What is the ‘scientific’ definition of climate impact for FIs?

Financial institutions climate actions need to lead to GHG emission reductions in the real economy

The latest review of academic literature (Kölbel et al, 2019) defines ***“investor impact as the change that investor activities achieve in company impact”*** through various mechanisms (engagement, capital allocation, indirect impacts), as opposed to the impact of the companies in the portfolio. It is consistent with previous research (Brest et al, 2018) and the IFC’s definition.



Conclusion 5

To achieve their targets, investors (or banks) need to influence the behavior of investee/client companies, leading to GHG emission reductions in the real economy.

Do you disagree with this conclusion?

Practitioners agree with this definition

IMPACT MANAGEMENT PROJECT

The Impact Management Project (IMP) is a forum that convenes a Practitioner Community of over 2,000 organisations to debate and find consensus (norms) on technical topics,

"IMP consensus on investor contribution strategies:
An investment's impact is a function of:
1. The impact of the underlying asset(s) / enterprise(s) that the investment supports, and
2. The contribution that the investor makes to enable the enterprise(s) (or intermediary investment manager) to achieve that impact.

The first two phases of the IMP achieved consensus on four strategies by which investors can contribute to the impact of the enterprises in which they invest (...):

- *Signal that impact matters*,*
- *Engage actively,*
- *Grow new or undersupplied capital markets,*
- *Provide flexible capital."*

*Often referred to as values alignment, this strategy expresses the investor's values and is an important baseline. But alone, it is not likely to advance progress on societal issues when compared to other forms of contribution

Source: Investor contribution in public and private markets - Discussion document, IMP, Jan 2019

Is it scientific to use portfolio alignment as a proxy for impact?

A change in portfolio exposure is not a valid proxy for GHG emission reductions in the real world

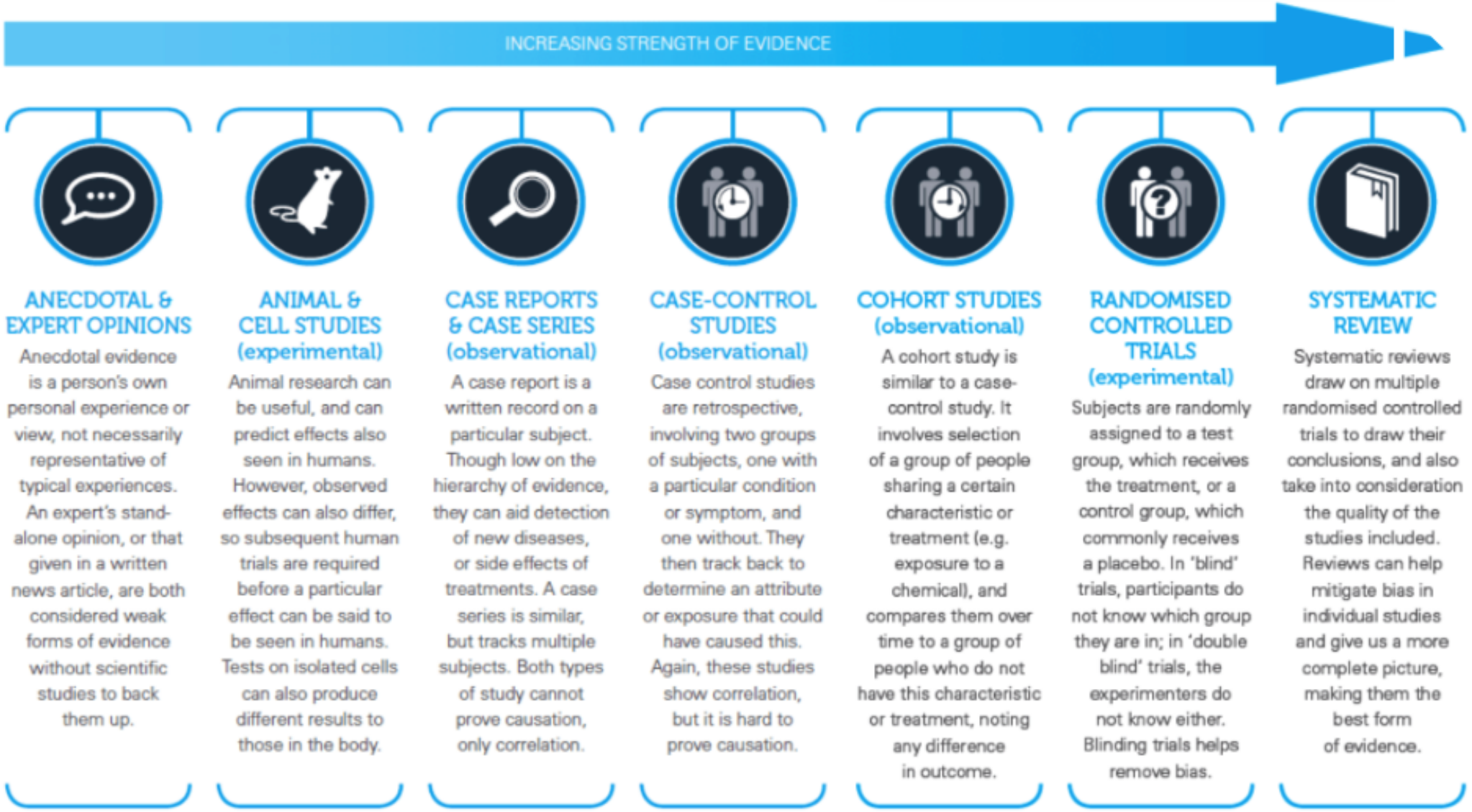
The latest review of academic literature (Kölbel et al, 2019) did not identify enough ex-ante evidence to assume that a change in portfolio exposure from high to low-carbon economic activities (a.k.a. 'alignment') automatically lead to changes in the real economy:

"While the impact of capital allocation may seem intuitive at first sight, it touches upon a rather fundamental question, namely to what extent the decisions of investors influence the course of the real economy. We were not able to find studies that relate the capital allocation decisions of sustainable investors to corporate investment activities or operational practices. Hence, direct ***empirical evidence for the capital allocation impact is lacking****." (Kölbel 2019)*

Conclusion 6

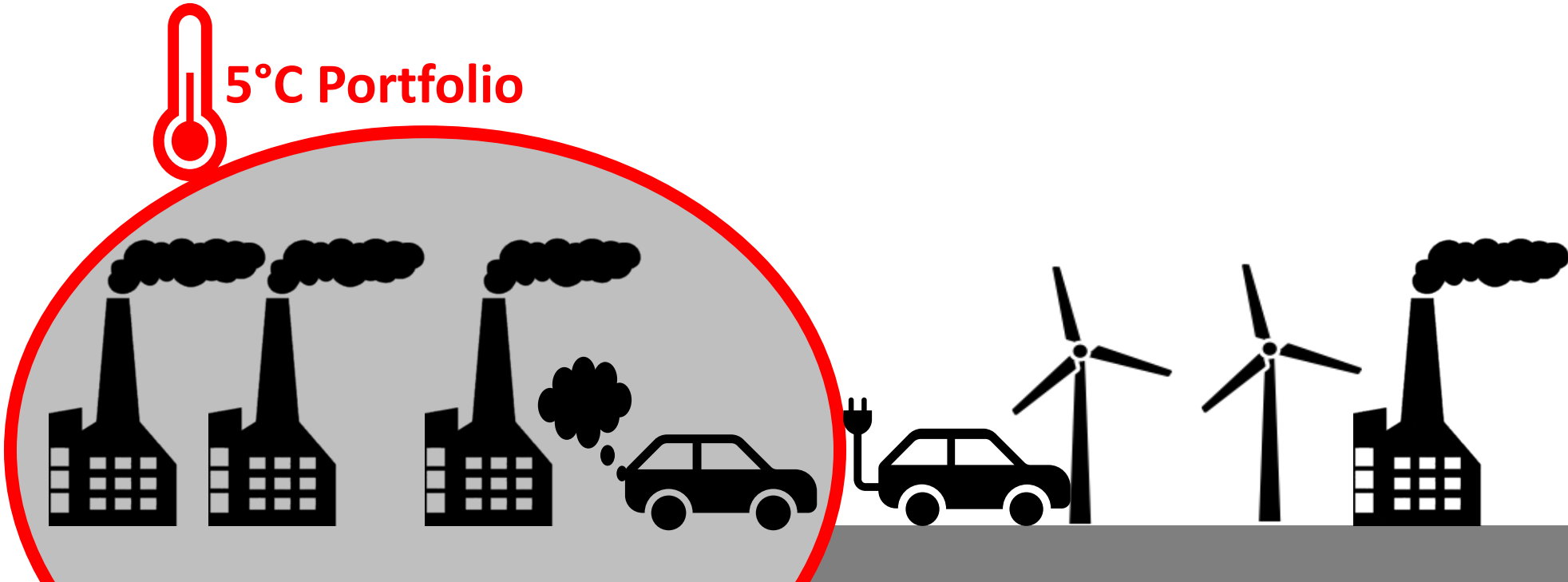
There is currently no scientific evidence that aligning the exposure of investment/lending portfolio with a 1.5°C pathway, whatever the metric used, (technology, carbon emissions, etc.) can serve as a proxy for measuring the related changes caused by the financial institution in the real economy.

Do you disagree with this conclusion?



Source: www.sciencemediacentre.co.nz/coveringscience/types-of-scientific-evidence/
Also see www.cebma.org/faq/what-are-the-levels-of-evidence/

A change in portfolio exposure is not a valid proxy for GHG emission reductions in the world



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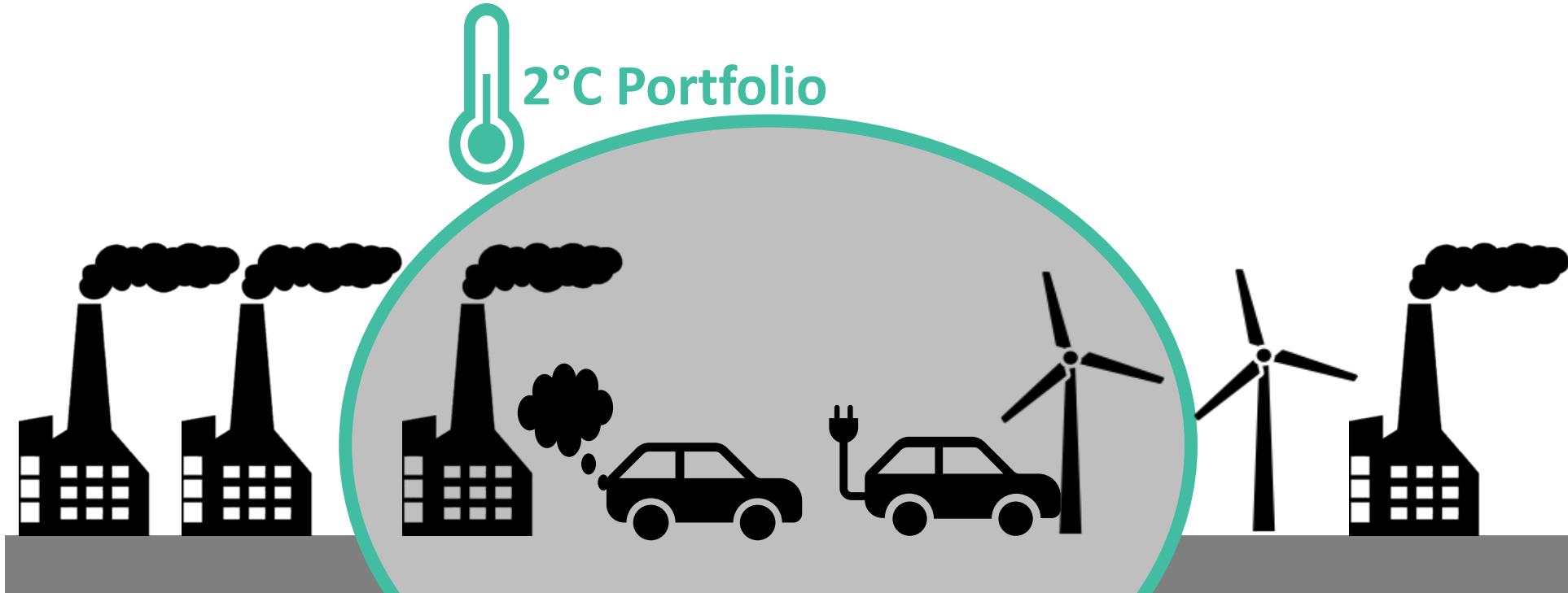


Practitioners acknowledge the scientific findings

IMPACT MANAGEMENT PROJECT

*"Investors should self-classify their investor contribution as "grow new or undersupplied capital markets" **if they have reason to believe that their investment itself directly caused or will cause**:*

- *A change in the amount, cost or terms of capital available to an enterprise that enables it to deliver impact that would likely not otherwise occur, or*
- *A change in the price of the enterprise's securities, which in turn pressures the enterprise to increase its social and/or environmental impact and/or rewards it for doing so.*

(…)

***The consensus of investors in public equity markets** is that the widely distributed nature of those markets means that **purchases and sales of small blocks of shares do not generally influence the market prices of securities or the behaviour of the underlying enterprises**. In such circumstances, it is not reasonable to expect public equities transactions to meet the above definition of "growing new or undersupplied capital markets."*

Source: Investor contribution in public and private markets - Discussion document, IMP, Jan 2019

*"There is a difference between the outcomes of portfolio climate alignment and the impact of absolute GHG emissions reduction in the real economy. Challenges such as carbon leakage present limitations to how much a bank can control in terms of climate impact" – **ING Terra report***

*"Divesting would make that number [GPIF alignment score] decrease, but simply be passing the ownership on to someone else who cares less about negative externalities" – **Hiro Mizuno, GPIF***

‘System change’ arguments are speculative

“Investors in public markets often describe the impact of “signaling that impact matters” strategies in terms of the contribution to systems change. That is, if all other investors did the same, it would lead to a "pricing in" of social and environmental impacts by the capital markets.

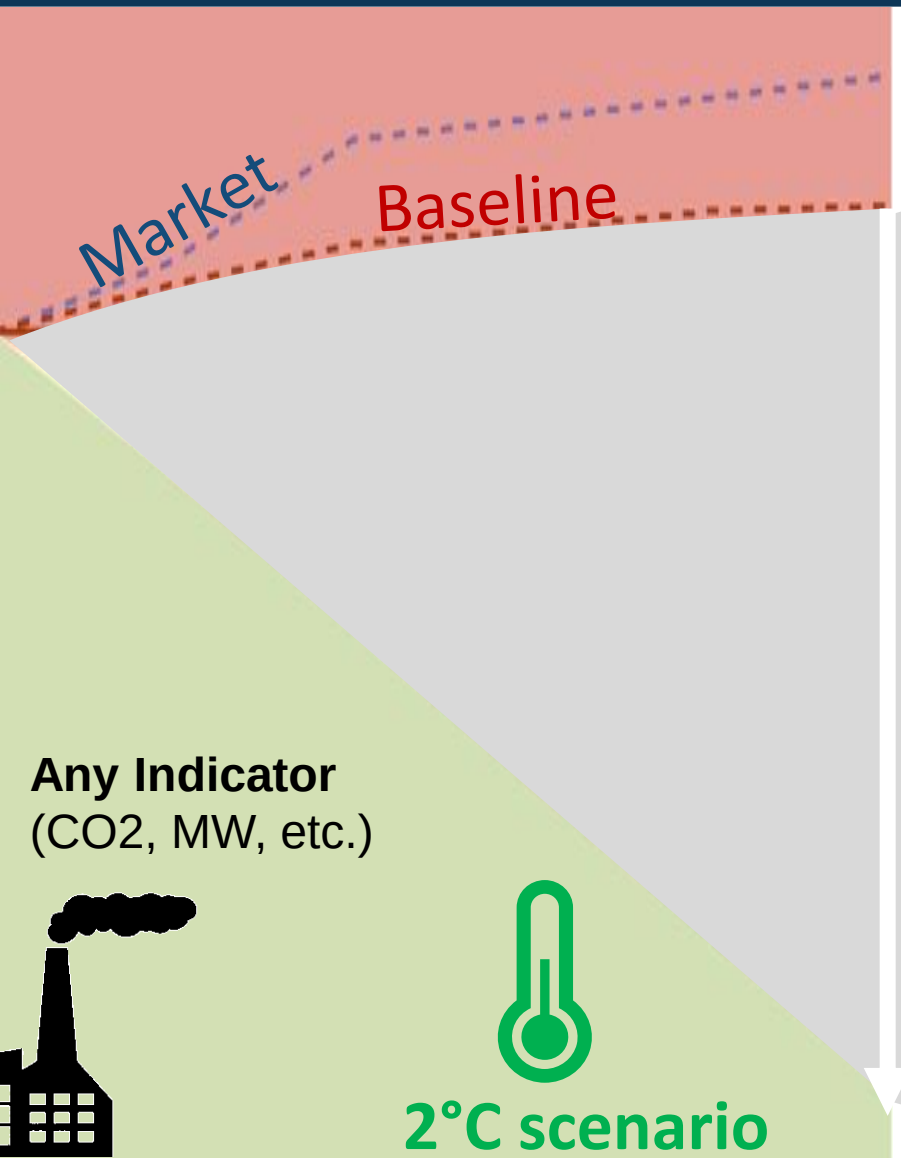
This is a topic of debate. Some public markets investors describe themselves as participating in or contributing to systems change in capital markets, while also acknowledging that their investments do not directly cause a change to people and planet. Other public markets investors point out that there are still empirical questions that would need to be addressed before concluding that the collective action of investors in public markets causes a change in corporate behavior (…)

In general, "systems change" arguments about the impact of investing in public markets tend to be speculative, depending on the possible behavior of large numbers of other investors now or in the future. *Some investors and asset owners find these arguments satisfactory; others do not. Empirically, much will depend on the proportion of investors that are "impact-motivated" versus "impact-neutral", and on the specific goals and tactics of both.”*

Source: Investor contribution in public and private markets - Discussion document, IMP, Jan 2019

“There is lots of debate about what constitutes a green financial service or product, and what more generally greenness amounts to. Most parties to that debate have assumed that holding green investments is sufficient to be green. That is not, unfortunately, sufficient. Simply investing in green doesn’t mean you’ve made the world greener.” (Caldecott, 2020)

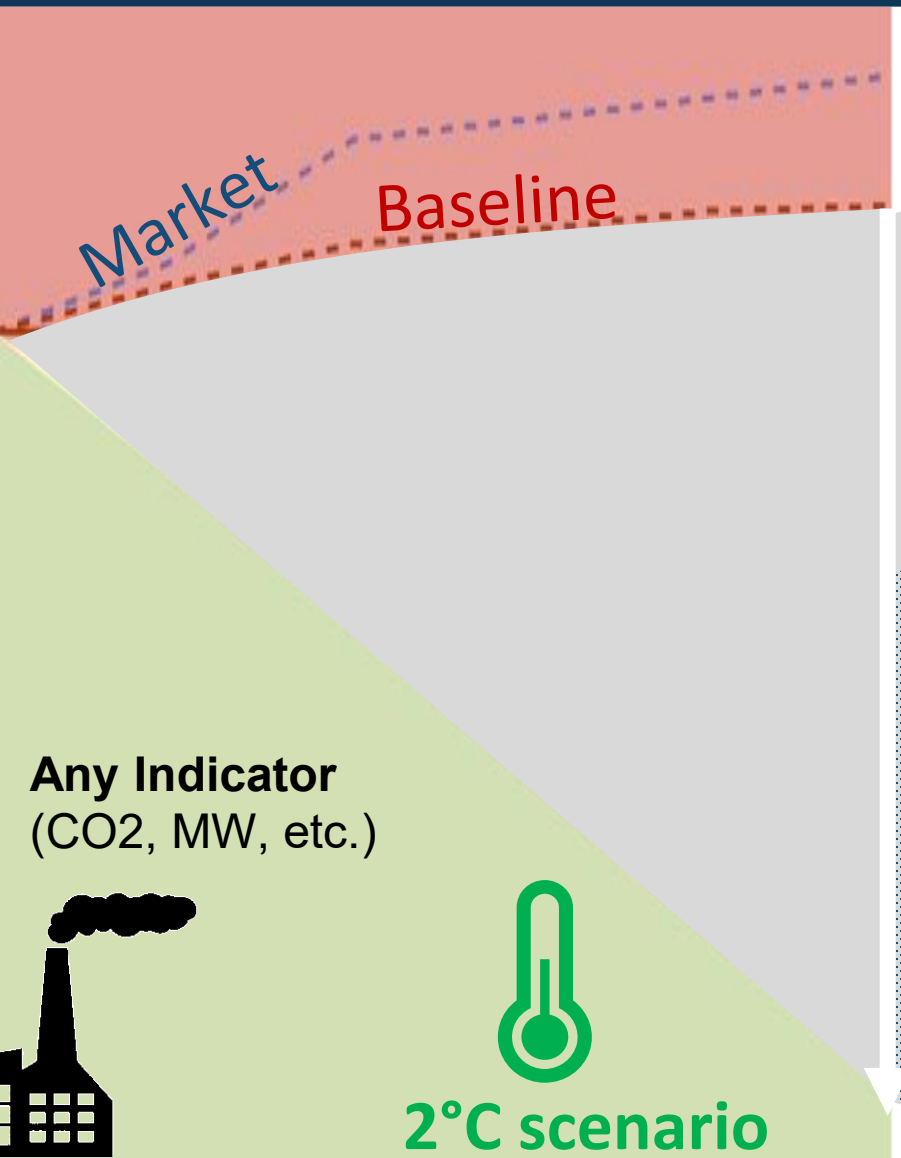
Is it ‘scientific’ to set targets on alignment to manage impact?



A Alignment gap = The volume (CO_2, MW…) associated with the portfolio that exceed the carbon budget in the scenario

This is what is calculated today when investors and banks calculate the alignment of their portfolio, and what the SBTi draft proposes to use as the underlying indicator for target setting

Is it ‘scientific’ to set targets on alignment to manage impact?

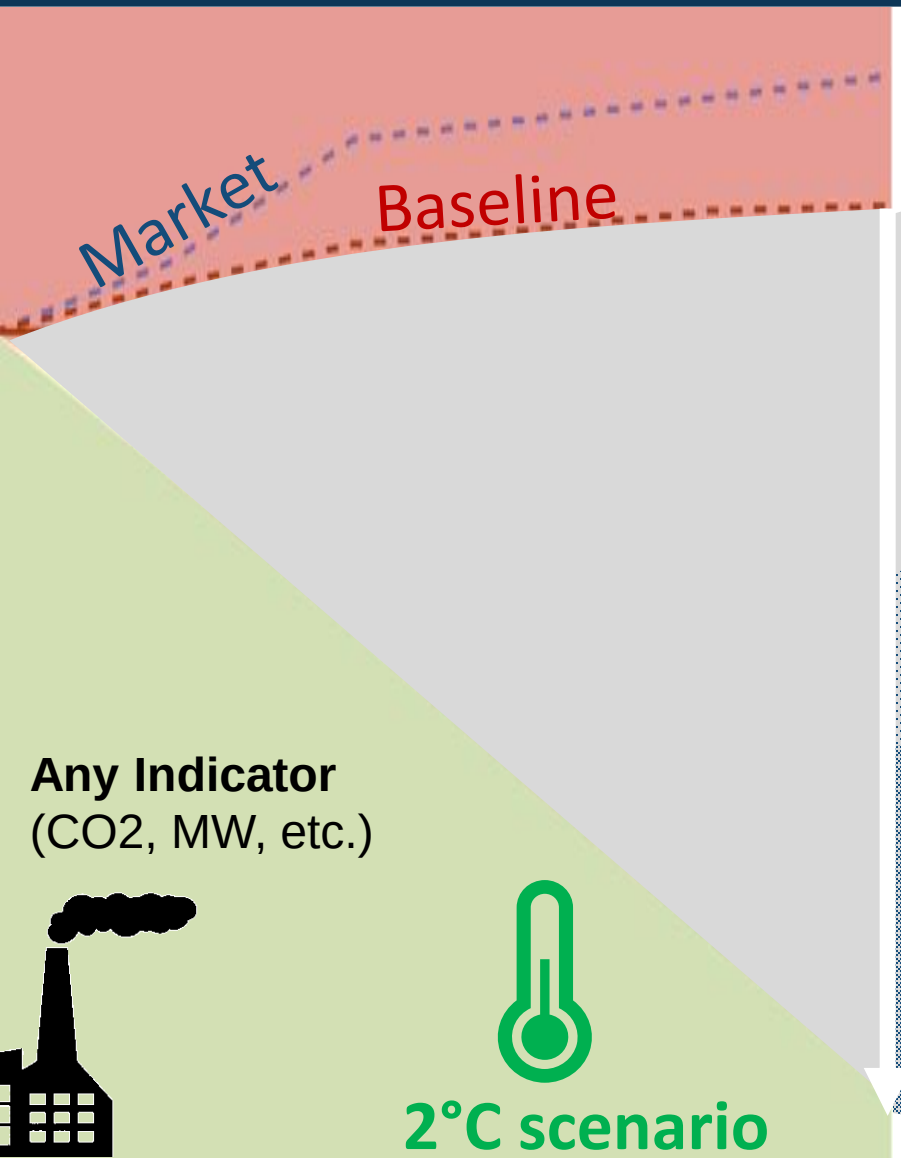


A Alignment gap = The volume (CO_2, MW…) associated with the portfolio that exceed the carbon budget in the scenario

B GHG reduction potential of companies targeted = The volume associated with the companies directly targeted by the climate action (e.g. voting, engagement, divestment…)

As an example, the actions of the Climate Action 100+ coalition target 160 companies (compared with 1650 constituents in the MSCI World). The SBTi draft criteria suggest engaging with a minimum of 30% of investees.

Is it ‘scientific’ to set targets on alignment to manage impact?



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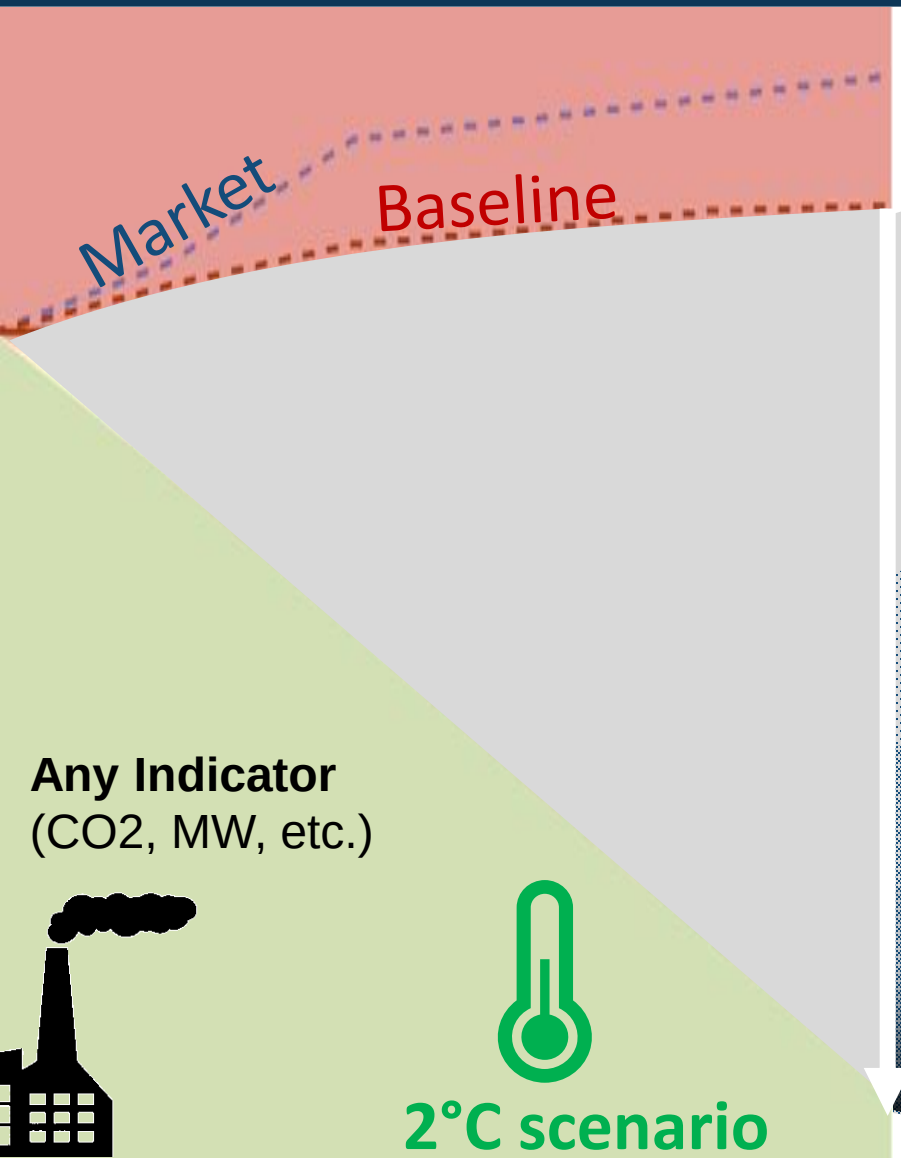
C GHG reductions observed = The actual emissions reduction that was observed over time across the companies targeted (B)

e.g. in its progress report the CA100+ coalition starts to track the progress made by targeted companies

Is it ‘scientific’ to set targets on alignment to manage impact?

You can’t ‘scientifically’ manage an indicator that you do not measure



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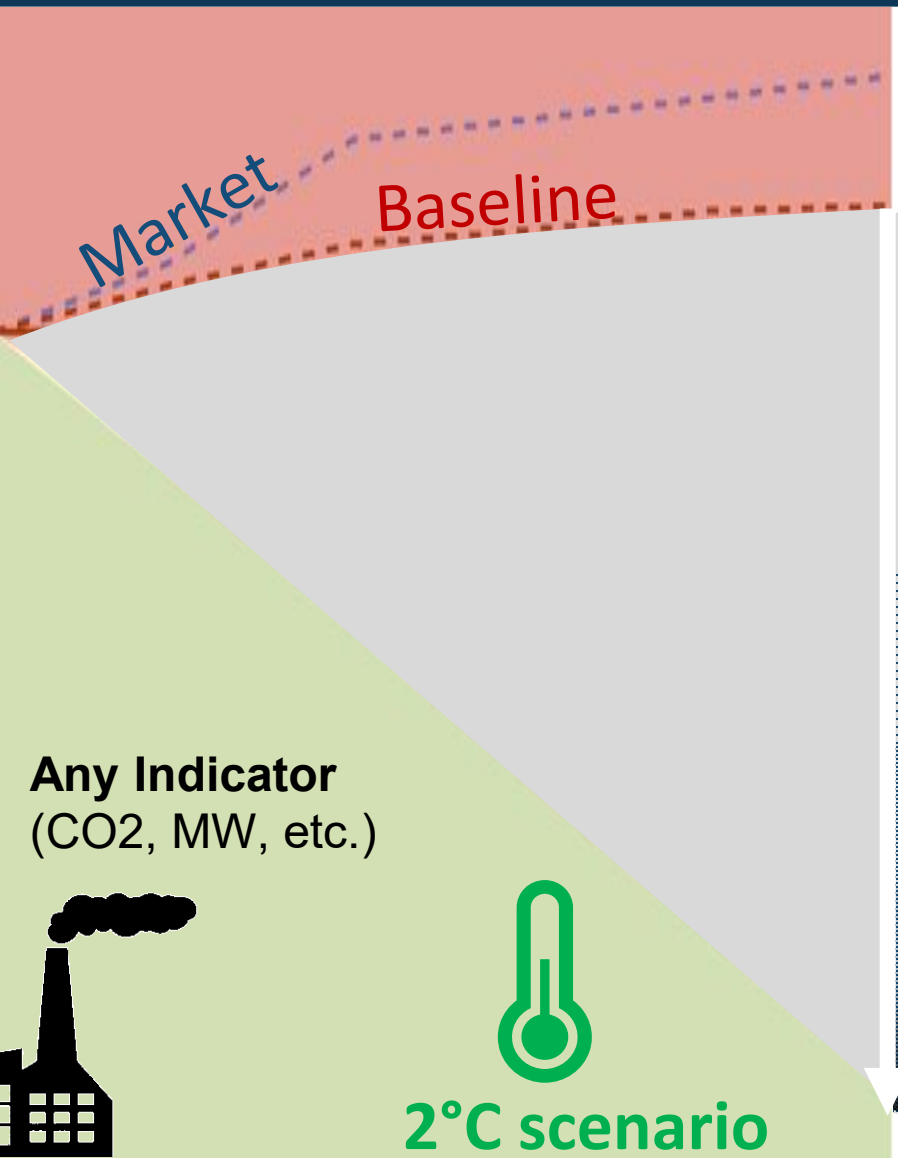
D **GHG reduction impact target** = Weight of the investors’ actions as a driver of the changes observed vs other factors (e.g. policies, cost…

This indicator is not calculated today

Is it ‘scientific’ to set targets on alignment to manage impact?

You can’t ‘scientifically’ manage impact by measuring exposure



A Alignment gap

B GHG reduction potential of companies targeted

C GHG reductions observed

D GHG reduction impact target

Conclusion 7

The alignment indicator (A) is likely to be very different from the impact indicator (D) and primarily driven by exogenous factors.

If a financial institution has the objective to improve its impact (D), Alignment (A) is likely to be a poor proxy.

As a result, changes in (A) are inappropriate as a ‘scientific’ measurement of progress towards (D).

Do you disagree with this conclusion?

Reasons behind 2Dii's withdrawal from SBTi for Financial Institutions*

+ questions about your opinion

*i.e. 2Dii does not co-develop the methodological framework anymore and does not endorse the outputs

Principle of *reality* of emission reductions

Setting targets on ‘virtual’ emission reductions seems inconsistent with the stated purpose of SBTi

In the context of the technical debate within the SBTI group, it has not been possible to find an agreement with the other organizations involved in the SBTi for financial institution project on the following statement:

> ”*The SBTi framework must prevent financial institutions from setting targets labeled as “science-based” and achieving them without providing any scientific evidence that their actions actually contributed to reducing GHG emissions in the real economy*."

As a result, the SBTi consortium decided to build the target setting framework based on the ‘system change’ assumption presented in slide 19.

Do you disagree with this principle?

Consistency with the GHG Protocol

SBTi's envisioned criteria are not consistent with the GHG Protocol in our view

Despite the scientific evidence that changes in portfolio allocation have no linear relationship with GHG emissions in the real economy, the conclusions of the SBTi consortium in terms of ensuring the need for real emissions reduction (see previous slides) seems – in our view- inconsistent with the guidance provided in the GHG Protocol Scope 3 Guidance (see excerpt below).

"To consistently track scope 3 emissions over time, companies shall recalculate base year emissions when significant changes in company structure or inventory methodology occur. In such cases, recalculating base year emissions is necessary to maintain consistency and enable meaningful comparisons of the inventory over time. Companies are required to recalculate base year emissions when the following changes occur and have a significant impact on the inventory: structural changes in the reporting organization, such as mergers, acquisitions, divestments, outsourcing, and insourcing(…) Significant changes result not only from single large changes, but also from several small changes that are cumulatively significant. (…) Structural changes trigger recalculation because they merely transfer emissions from one company to another without any change in emissions released to the atmosphere (e.g., an acquisition or divestment only transfers existing GHG emissions from one company's inventory to another)."

– ***Corporate Value Chain Accounting & Reporting Standard* (p. 104)**

Do you think this rule should be applicable to financial institutions?

Regulatory and legal implications

We identify a risk of leveling down the playing field and facilitating misleading impact claims

The EU regulatory guidance says that *"claims should be based on robust,* ***independent, verifiable and generally recognized evidence*** *which takes into account the* ***latest scientific findings and methods."***

By presenting itself as independent and science-based, the SBTi project as currently designed is likely to **level down the playing field** and undermine the enforcement of existing consumer protection and unfair competition regulations. The current criteria seem inconsistent with the science as presented as in the previous section and potentially misleading.

Do you agree with our interpretation?

Our analysis of current environmental marketing claims in Europe suggests that many fund manager make *'investor impact'* claims, and that most of them do not comply with applicable regulatory guidelines.

These practices take place in a context in which about 40% of consumer declare that they want to have a measurable environmental impact with their money, in line with the academic definition of 'investor impact'.

We fear the SBTi process may reinforce this dynamic.

Request the compliance review (draft)

Carbon footprinting and related ‘targets’ or ‘performance’ are often associated with misleading claims confusing company and investor impact

“Last year, the equity fund was directly responsible for 1,417 tonnes of CO_2 emissions based on this calculation. A very good value, as the comparison with the MSCI index shows that our fund has a significantly lower impact on climate”

“What does this mean for you as an investor? An investment of 100,000 euros in the fund helps avoid CO2 emissions by 400 tons, or the equivalent of 60 trips around the world with a car.”

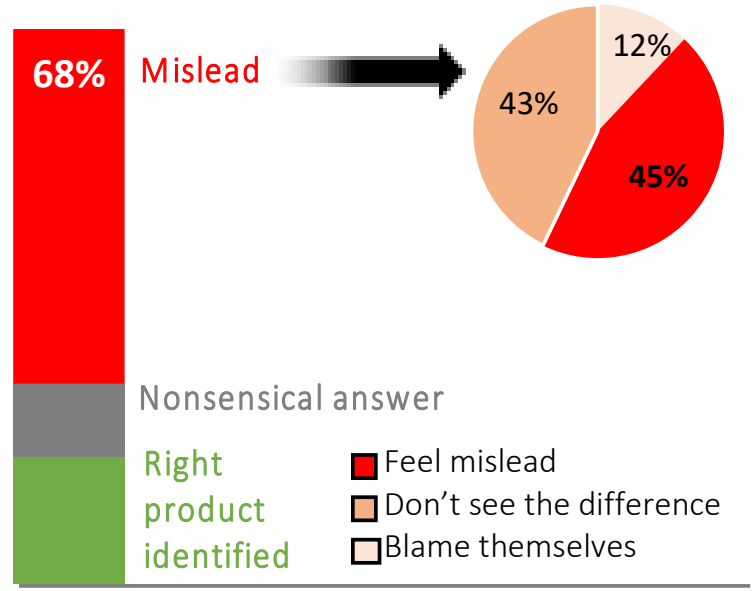
“A 5 million Euro investment in the fund, for one year would reduce polluting emissions by 4,200 tons of CO2, which is equivalent to taking 1,900 cars off the road for a year.”

“Invest 25,000€ in this fund and you save the CO2 emissions equivalent to: Flying 7,3000 km, Eating 830 burgers, using 7,000 times your washing machine”

Source: analysis of marketing material of retail funds distributed in Europe, by 2Dii legal team (2020).
The wording has been slightly modified to ensure the anonymity of the quote.

When marketing claims confuse ‘investor impact’ with ‘company impact’ and communicate on related GHG emission targets, 2/3 of consumers are misled

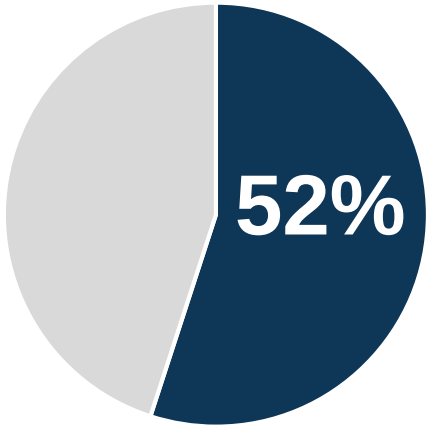
Claim: “*The Equity Fund” allows investors to have a real impact on climate change. The design of the fund aims at generating a real impact on the environment and create solutions for climate change: For example, a 5 million Euro investment in the fund, for one year would reduce polluting emissions by 4,200 tons of CO_2, which is equivalent to taking 1,900 cars off the road for a year. These figures are reported every year and audited.*”

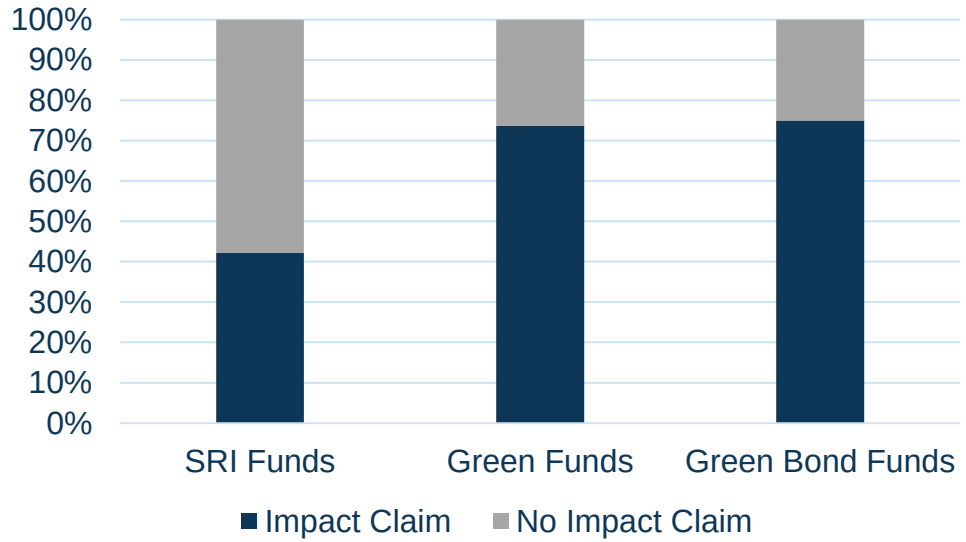


Source: Splendid research/2Dii. In Q3 2019, 2,000 German retail investors and 2,000 French retail investors were asked to associate the claim with a technical description of the product and its environmental benefits *“Based on this description, which of the following sentences most accurately describe(s) your understanding of the environmental characteristics associated with this product?”.*

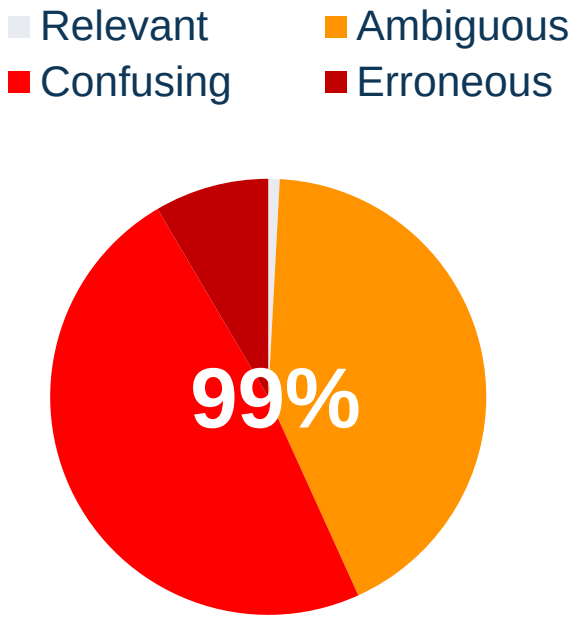
Today, such non-compliant marketing impact claims are the norm rather than the exception

52% of sustainable funds in our sample make a claim on environmental impact of the investment strategy [a.k.a. investor impact]. The figure is much higher for green equity and bonds funds





For 99% of the funds, the claims are misaligned with regulatory guidelines



Fund selection : 240 European retail funds, representing €130 Billion in AUM, explicitly presented as having a link to environmental through the implementation of SRI, Green thematic and Green bond approaches (2Dii 2019)

Source: 2Dii analysis based on Regulatory guidance (EU Multi-stakeholder Dialogue on Environmental Claims) associated with the Unfair Commercial Practices Directive

On top of being misleading, some ‘GHG reduction targets’ set by investors are manipulative: they are easily achieved without any change in either the emissions of the investees (impact) or in portfolio exposure.

Examples of claims:

“We will reduce the carbon footprint of our listed equity portfolio by 40% in 2027 relative to 2017”

“Between 2015 and 2023, we commit to reducing the carbon intensity of our overall portfolio by 25%”

	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7	Year 8	Year 9	Year 10
CO_2 emissions	100	100	100	100	100	100	100	100	100	100
Asset price	$ 1.00	$ 1.07	$ 1.14	$ 1.23	$ 1.31	$ 1.40	$ 1.50	$ 1.61	$ 1.72	$ 1.84
CO_2 intensity	100	93	87	82	76	71	67	62	58	54
CO_2 intensity reduction rate	0%	-7%	-13%	-18%	-24%	-29%	-33%	-38%	-42%	-46%

Calculation based on a 7% annual growth of the asset price. The target is still met with a 3.5% annual growth rate.

Recommendations to financial institutions interested in setting science-based targets

+ 2Dii actions on the topic

Help develop investor impact measurement methodologies

Several collaborative research projects aim at building evidence on investor and bank impact

The Impact Management Project (IMP) is a forum for building global consensus. They convene a Practitioner Community of over 2,000 organisations to debate and find consensus (norms) on technical topics, and share best practices. It also coordinates efforts to provide complete standards for impact measurement, management and reporting (IMP Structured Network)

CSP is a research and teaching unit at the Department of Banking and Finance of the University of Zurich in Switzerland. Their current research program involves collecting and analyzing scientific evidence on investor impact across different asset classes, and developing practical tool to manage impact.

Invecat is a 3-year EU-funded research project led by 2Dii and involving the UNFCCC Secretariat, the UNEP-FI and WWF. One of its objectives is the development of an 'investor impact' assessment methodology and its integration into 2Dii's PACTA tool (see next page).

Are you aware of other relevant projects?

Start collecting ex-post evidence on the impact of your actions

Several projects aim at managing investor and bank impact

Climate Action 100+ is an investor initiative coordinating engagement activities and shareholder resolutions on a list of 60 high carbon companies. 370 investors with more than $35Tn AuM have joined it. The coalition publish an annual ‘progress’ report, making it a good home for data and evidence collection.

UNEP-Fi coordinates the Principle for Responsible Banking (130 Banks) and the Collective Commitment to Climate Action (36 banks), which involved commitment to manage impact and set impact targets. They offer a good field for the pilot testing of emerging impact methodologies.

PACTA is a portfolio climate scenario analysis tool developed by 2Dii for investors and banks. It is used by 700 financial institutions with $60Tn of assets, and endorsed by several public authorities. The platform provide a good channel to document actions and collect evidence on their effect on companies activities

Don’t confuse alignment goals with science-based targets

Tracking portfolio alignment with climate goals and setting intended trajectories is a relevant step

Examples of alignment goals

“Transitioning our investment portfolio to net-zero GHG emissions by 2050”

“Aligning our lending portfolio to reflect and finance the economy required to limit global warming to well-below 2°”

“The Dashboard demonstrates the CO2 equivalent (CO2e) intensity per sector of our portfolio compared to the market and the relevant climate scenario. It also displays the climate alignment target per sector and our intended decarbonisation pathway”

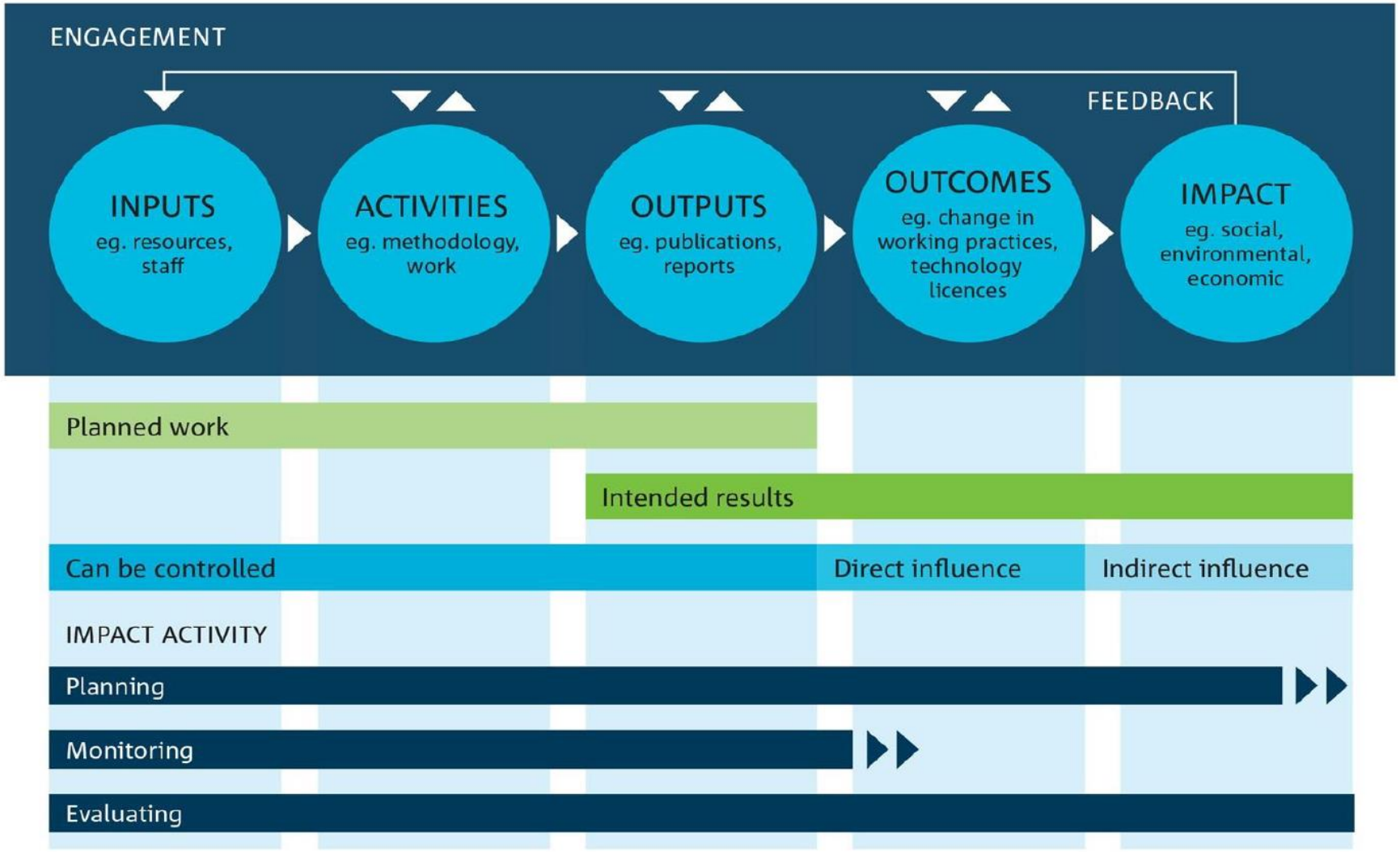
Do you agree with this distinction?

Best practices of disambiguation

“There is a difference between the outcomes of portfolio climate alignment and the impact of absolute GHG emissions reduction in the real economy. Challenges such as carbon leakage present limitations to how much a bank can control in terms of climate impact, especially when applying capital allocation choices as a tool for steering”. **ING terra report**

Setting ‘alignment goals’ is relevant to define the intended average trajectory for the investee/client companies. However it is not to be confused with a ‘science-based target’ that, by design, only applies to real GHG reductions.

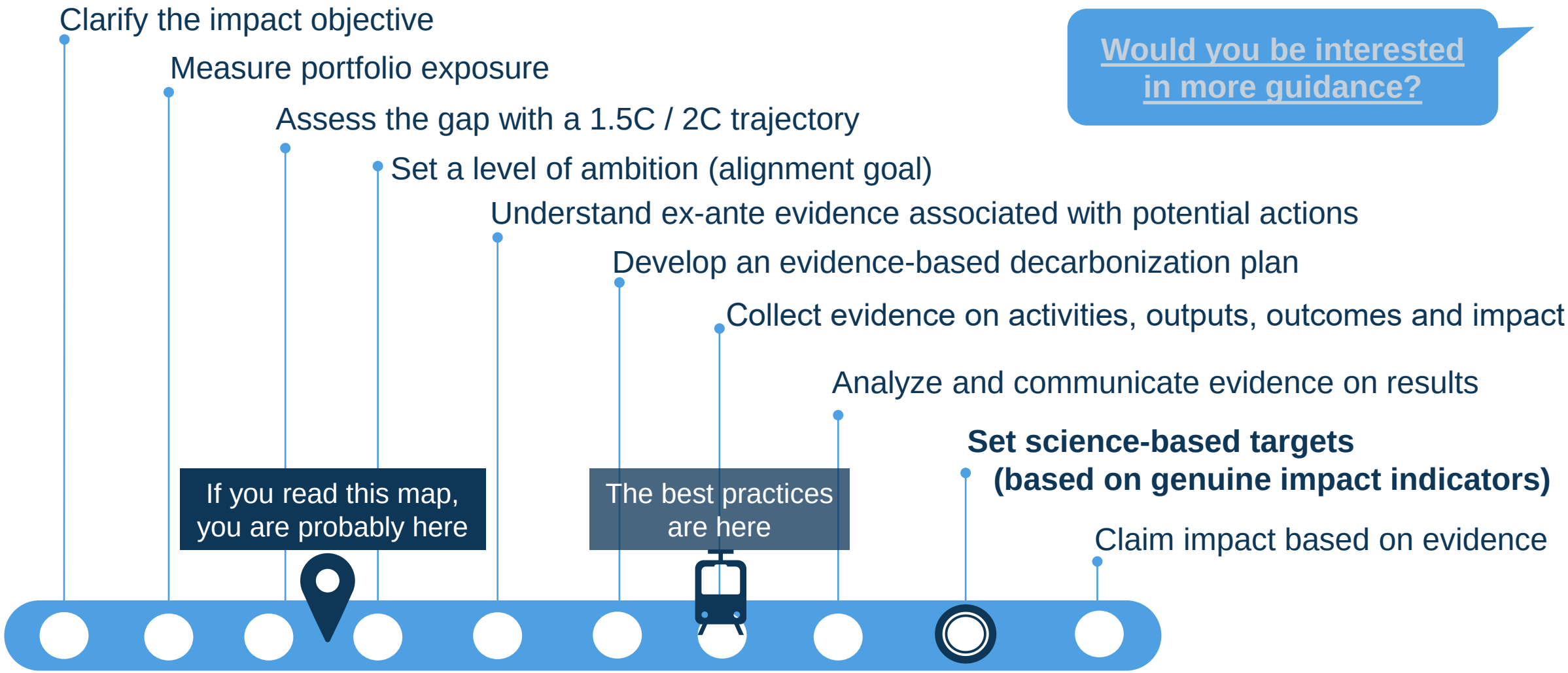
CICERO conceptual framework, referenced in ING's report



Impact Framework derived from the work of the *W.K. Kellogg Foundation*

Suggested journey to science-based target setting

We estimate that it will be possible for investors to set science-based targets in 2 to 5 years



Join our ‘Evidence on impact’ program

Several collaborative research projects aim at building evidence on ‘investor/bank impact’

POLICY POSITION

Our objective is to level up the playing field in order to avoid unfair competition. Provide feedback on this presentation and upcoming papers to help us build a public position regarding the standard of evidence required to substantiate backward-looking and forward-looking climate impact related claims.

METHODOLOGY DEVELOPMENT

Various organizations currently build and road-test ‘investor impact’ measurement methodologies. However most approaches only outline general principles and the practical tools available are limited. Building on their findings, and our partnership with investors and banks we want to contribute to enhancement and deployment of methodologies.

EX-POST EVIDENCE COLLECTION

We will leverage our PACTA tool to collect turn methodologies into a practical module that will collect evidence on activities, outputs and outcomes and made the data (under NDA) available to researchers in order to analyze the impact, improve the methodologies and calculate ‘impact indicators’

Would you be interested in participating?

Visit our website: 2Dii.org