CLIMATE BENCHMARKS:

The European Union misses out on the Paris Agreement

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EXECUTIVE SUMMARY

With its "benchmarks regulation[1]", the European Union wishes to create a common basis of minimum criteria to meet for "green" financial indices, and thus contribute to making finance compatible with the goals of the Paris Agreement.

This regulation consists of the creation of two "benchmarks" of climate indices that provide a scheme to be respected for any green financial index. The two proposed index benchmarks are **aimed at all index administrators and will allow them to use the name "Paris Aligned Benchmark" (PAB) or "Climate Transition Benchmark" (CTB) in the name of their indices if they comply with the defined criteria[2].**

This regulation is particularly important and expected given the continuous development of passive index management, which merely replicates selected indices. Passively managed funds represent more than 20% of assets under management worldwide[3]. Moreover, this type of management, which is already the standard across the Atlantic, is set to gain momentum in Europe. While asset managers increasingly recognise the need to align their investments with the Paris Agreement, **exclusion policies or commitments made in this direction are almost always limited to actively managed assets[4], leaving index funds and passive management aside.** For example, Lyxor AM and BlackRock, which respectively manage nearly half and more than two-thirds of their assets passively, do not apply their coal policy to their passive assets.

In face of the climate emergency, we cannot ignore the blind spot that these index funds and the $10 trillion of assets invested in them represents[5], especially since this amount is expected to increase by almost 10% by 2024[6].

While the EU initiative is welcome, **the two European benchmarks remain insufficient to allow a proper alignment of funds with the Paris Agreement goals.** Neither requires an absolute reduction in greenhouse gas emissions. Although the PAB goes further than the CTB by introducing sectoral exclusions, it also does not guarantee the exclusion of companies developing new fossil fuel projects.

Therefore, financial institutions wishing to align their activities with a sustainable climate trajectory cannot be satisfied with these two benchmarks. They must develop indices based on the PAB enhanced with additional criteria to contain the rise in emissions and the development of fossil fuels. If there are not enough indices that meet these criteria, financial institutions, regulators and index providers must support their development.

What is a financial index?

Financial indices are indicators that bring together a certain number of stocks from a given sector or market, and that make it possible to measure the performance of that sector or market. They have become essential tools of international finance. Indices are replicated by passively managed funds, which allocate capital to follow as closely as possible the evolution of their benchmark index. They also provide a benchmark for the performance of actively managed funds.

GREEN INDICES, WATCH OUT FOR GREENWASHING

Faced with rising climate challenges and an increasing demand for green products, particularly from institutional investors, index providers[7] have built "green", "climate" or "sustainable" indices.

Such indices, as well as similarly named funds, have heterogeneous methodologies, which opens the door to greenwashing. A study by Morningstar[8], which lists more than 400 European investment funds with climate-related objectives, shows that the content of the funds varies considerably, without guaranteeing progress against climate change. Even where a label exists, it rarely guarantees "green" or ethical products: 94% of the 36 SRI-labelled funds studied by Reclaim Finance contain companies with problematic environmental and social practices[9].

Similarly, **it is nowadays difficult to track the composition of indices labelled as "green" or "sustainable" and their environmental impact, especially as most of them do not aim for alignment with the Paris Agreement. For example, Total is among the 10 largest components of the Dow Jones Sustainability Europe Diversified** index despite still developing new fossil fuel projects. It is also common to find so-called "low carbon" indices that do not apply any strict exclusion to fossil fuels[10]. For example, the MSCI World Low Carbon Target Index[11] has a 7% exposure to fossil fuels and does not apply any strict exclusion criteria in its methodology.

A WELCOME REGULATION

It is eminently necessary to adopt binding regulation forcing indices self-attributed as ecologically virtuous to comply with minimum criteria. The European Union's initiative in this area is particularly welcome.

Following lengthy work, the European Union has produced two climate index benchmarks that provide a scheme to be followed. However, although the European institutions have of course taken the Paris Agreement as a reference, they have unfortunately stopped halfway. Neither of the two European "benchmarks", the Climate Transition Benchmark (CTB) and the Paris Aligned Benchmark (PAB)[12],provides for the exclusion of developers of new fossil fuel projects.

THE MAJOR PITFALL OF THE TWO BENCHMARKS

The PAB and CTB require an annual reduction in carbon intensity of the index of 7% but do not speak of absolute emissions. However, a reduction in carbon intensity can be accompanied by an increase or stagnation in total emissions. This is particularly the case for oil companies such as Total, which are committed to reducing the carbon intensity of their production while ramping up production[13]. Moreover, the 7% target is set for the index as a whole and not for each of the companies in the index, allowing some companies that do not meet this trajectory to remain in the index if other companies exceed this target.

ZERO TRANSITION FOR THE CLIMATE TRANSITION BENCHMARK

CTB does not exclude any activity from its investment scope. Following a "best-in-class" approach, all activities are put on an equal footing, and only the "worst" companies in each sector are excluded. This brings CTB closer to the current so-called "low carbon" indices. **While it bears the word "transition" in its name, this benchmark denies the need to phase out certain activities intrinsically incompatible with limiting global warming to 1.5°C. Thus, not only are fossil fuel companies not excluded from the benchmark, they can also remain included despite increasing their investments in these sectors.**

BIG OMISSIONS FOR THE PARIS ALIGNED BENCHMARK

The "Paris Aligned benchmark" goes further than the CTB by coupling the annual GHG emissions reduction target to an activity-based exclusion list. **Companies generating more than 1% of their revenues from coal, more than 10% from oil, and more than 50% from gas are excluded from the PAB[14]. However, companies developing new fossil fuel projects, including in the riskiest sectors[15], could still be included in the PAB, provided they have a sufficiently diversified activity to remain below these exclusion thresholds.** This pitfall is all the more problematic given the PAB does not plan for a gradual lowering of the exclusion thresholds in line with a trajectory of alignment with the Paris Agreement. However, any new project for the extraction or exploitation of fossil fuels is incompatible with the remaining carbon budget to limit warming to 1.5°C. As our window for action is very narrow, under 10 years[16], authorizing the development of new fossil fuel projects condemns millions of people to suffer the impacts of climate change and exposes millions of others to a brutal and even more costly transition.

The way forward

Index funds with environmental and climate-related objectives must at least replicate indices that comply with the PAB. As the PAB is not sufficient, we believe it is necessary to add the following criteria:

1. **A target for an absolute reduction of annual emissions:**
   - The reduction of absolute emissions by at least 7%.
   - The exclusion of companies that do not meet the 7% absolute emissions reduction target two consecutive years.

2. **The exclusion of companies developing new fossil fuel projects, including:**
   - New hydrocarbon exploration or exploitation projects.
   - New coal extraction or electricity production from coal projects.

3. **A reinforcement of current exclusion thresholds:**
   - The exclusion of companies that derive more than 5% of their production from the exploitation of non-conventional hydrocarbons.
   - The application of PAB thresholds on the share of coal, oil or gas in a company's activities to production and not only to income.

4. **A dynamic approach geared towards the gradual phase-out of fossil fuels:**
   - A gradual lowering of thresholds for oil and gas to ensure an exit from oil and gas by 2040 at the latest in European and OECD countries and by 2050 in other countries,
   - The exclusion of companies that have not adopted a detailed plan to phase out coal assets—before 2030 in European and OECD countries and 2040 in other countries—by 2021.

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Reclaim Finance is an NGO affiliated with Friends of the Earth France. It was founded in 2020 and is 100% dedicated to issues linking finance with social and climate justice. In the context of the climate emergency and biodiversity losses, one of Reclaim Finance's priorities is to accelerate the decarbonization of financial flows. Reclaim Finance exposes the climate impacts of some financial actors, denounces the most harmful practices and puts its expertise at the service of public authorities and financial stakeholders who desire to to bend existing practices to ecological imperatives.

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