Enhancing market transparency in green and transition finance

Virtual session (joint with CEBRA) at ABFER Annual Conference

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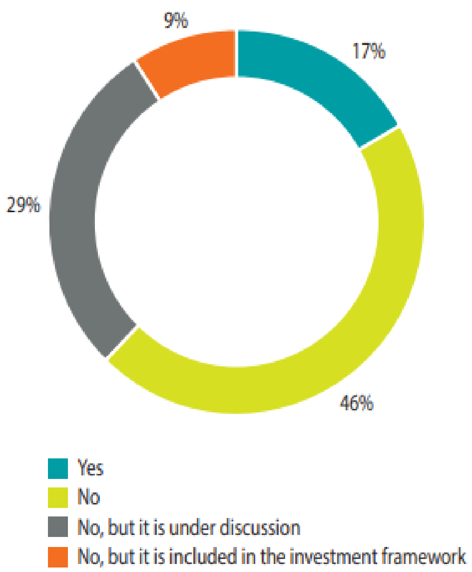
CHAPTER 3

Executive Summary

- **III. Climate transition metrics, frameworks and market products**
  - **Climate transition metrics and frameworks are important tools for central banks and financial authorities** that may be looking to assess and guide an orderly climate transition through the use of market-based approaches.
  - **A range of transition frameworks are emerging** to help assess factors such as issuers’ awareness of climate transition risks, ambition and readiness to decarbonise, governance and strategy, and medium and long-term science-based net zero targets.
  - **Progress is being made to develop market products** to help scale up investments in support of climate transition opportunities and green technologies.
  - Yet **challenges need to be addressed with respect to consistency, comparability, and credibility of metrics, frameworks and investment products**. Funds and ETFs labelled as climate solutions, low-carbon, climate-conscious, and clean energy differ widely in terms of how they measure emissions and carbon intensity.

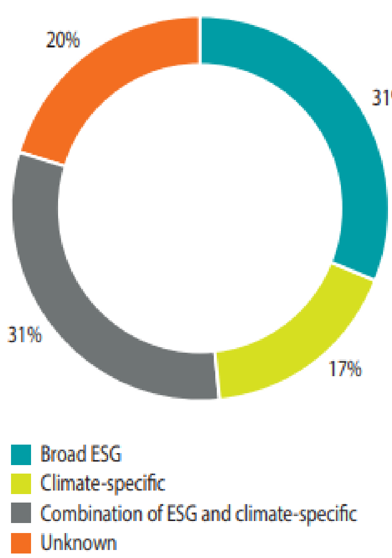
Central banks at various stages of incorporating ESG and climate-specific risks

Graph 3.1 **Central banks – Incorporation of ESG and climate-specific risks**



N = 114.
Source: World Bank Treasury.

Sustainable and Responsible Investment (SRI) scope taken by central banks

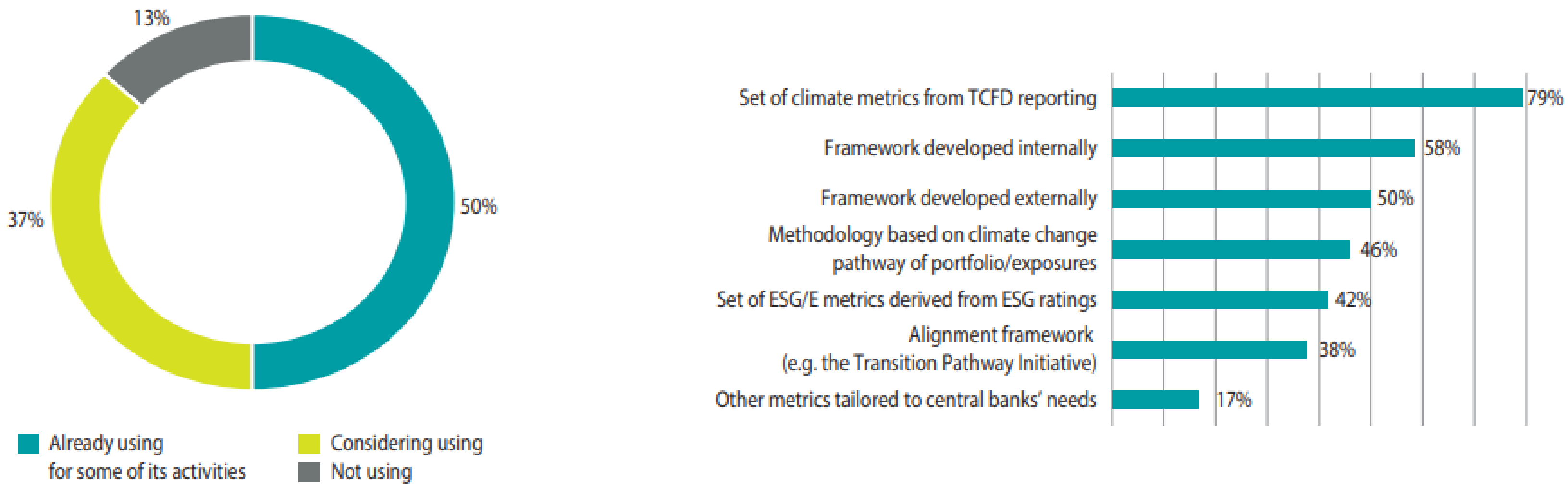


N = 35 (all surveyed central banks that adopt some form of SRI practices in one or more of their portfolios).
Source: NGFS portfolio management survey 2020.

NGFS Survey – climate metrics and frameworks

- The NGFS survey of central banks in 2021 explored the extent to which they are using climate-related metrics and climate transition frameworks with respect to activities, such as for market surveillance, financial stability, and own portfolio

Graph 3.2 **Central banks' use of framework/metrics to assess climate transition risks**



N = 24
Source: NGFS survey.

Carbon transition metrics

Table 3.2 **Common High-level Carbon Metrics**

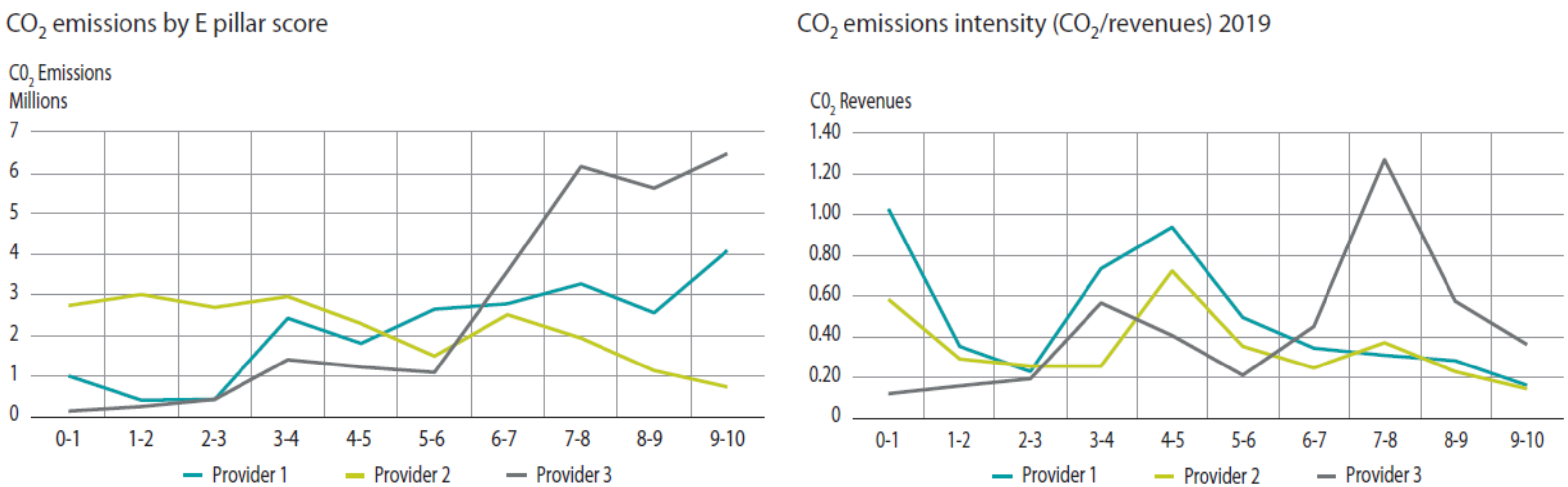
Metric	Description
Portfolio Carbon Footprint	• Total carbon emissions for a portfolio normalized by the market value of the portfolio, expressed in tons CO_2 emissions/$M invested.
GHG Emissions *Absolute Scope 1, Scope 2, and Scope 3*	• Absolute Scope 1, Scope 2, and Scope 3 GHG emissions. • Financed emissions by asset class. • GHG emissions per MWh of electricity produced. • Gross global Scope 1 GHG emissions covered under emissions-limiting regulations.
Carbon Intensity	• Volume of carbon emissions per million dollars of revenue (carbon efficiency of a portfolio), expressed in tons CO_2 emissions/$M revenue.
Exposure to Carbon-Related Assets	• The amount or percentage of carbon-related assets in the portfolio, expressed in $M or percentage of the current portfolio value.
Transition Risks *Assets or business activities vulnerable to transition risks*	• Volume of real estate collaterals highly exposed to transition risk. • Concentration of credit exposure to carbon-related assets. • Percent of revenue from coal mining.
Climate-Related Opportunities *Revenue & assets aligned with climate-related opportunities*	• Net premiums written related to energy efficiency and low-carbon technology. • Number of (1) zero-emissions vehicles (ZEV), (2) hybrid vehicles, and (3) plug-in hybrid vehicles sold. • Revenues from products or services that support the climate transition. • Proportion of homes delivered certified to a third-party green building standard.

Sources: TCFD (2020 and 2021).

The Environmental Pillar of ESG

- The E of ESG is used to gain insight with climate alignment, yet it is not often fit for purpose.
- E scores from ratings providers often do not often align with lower carbon emissions or intensity.

Graph 3.3 **ESG ratings providers' E pillar ratings compared to measurements of GHG emissions**



Note: Average tonnes of estimated CO_2 and CO_2 equivalent emissions (Scope 1 and Scope 2, as reported by Refinitiv's methodology for estimating emissions) by E pillar deciles for different providers.

Note: Average tonnes of estimated CO_2 distributed by Revenues, by E pillar deciles for different providers.

Sources: Bloomberg, MSCI, Refinitiv, OECD calculations.

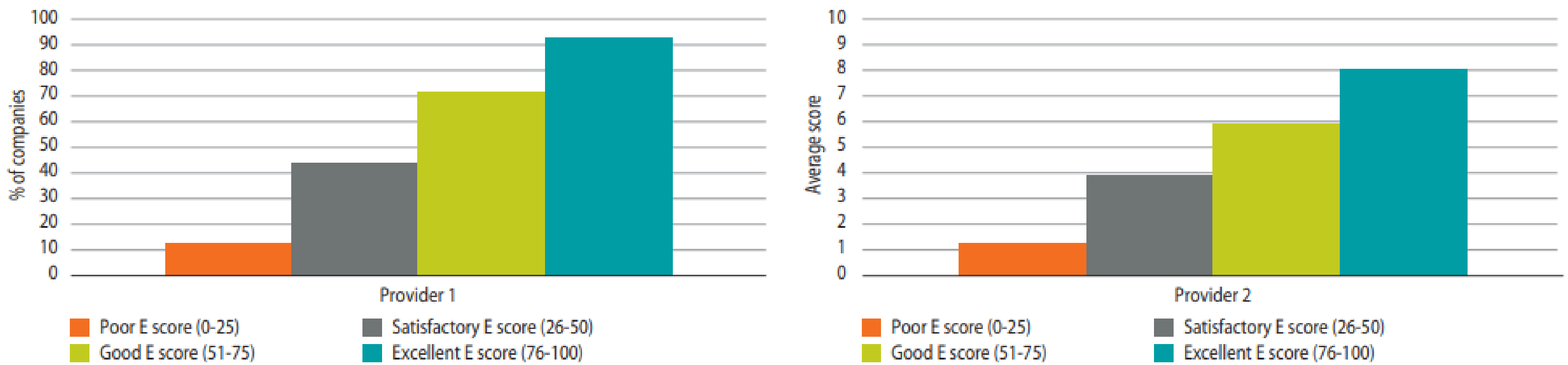
E pillar scores and climate transition?

- Some ESG providers capture disclosure of *awareness* of climate change risks and opportunities, plans and policies, and governance.
- Yet net zero targets, and implementation against targets, and not well measured.

Graph 3.4 **Relationship between the environmental pillar score and climate transition issues**

Share of companies disclosing awareness of climate change risks and opportunities

Climate change risk category score



Note: Metrics on diclosure of policies are binary (1 = true (company discloses awareness); 2 = false (company does not disclose awareness)). Information provided for 2,870 companies. Classification is based on Refinitiv ESG scores' quartiles.
Sources: Bloomberg, MSCI, Refinitiv, OECD calculations.

Growing availability of climate-related metrics and frameworks

- Central banks and market participants are increasingly using a range of climate-related metrics and frameworks.
- There are a number of similarities across core information (eg emissions, net zero targets) but also many differences that challenge comparability.

Metrics

- Environmental Pillar metrics from major ESG raters.
- Climate transition metrics from TCFD reporting guidance.
- Key metrics used in *climate transition frameworks*.

Frameworks

- Climate Action 100+
- Transition Pathway Initiative
- Science-Based Targets Initiative
- GFANZ (evolving)
- Private sector (eg MSCI net zero tracker)

Metrics in climate transition frameworks

Target Setting

- Most capture net-zero targets
- Interim (eg 2030) targets

Emissions

- Ranges from absolute to net emissions
- Some also balance absolute with carbon intensity

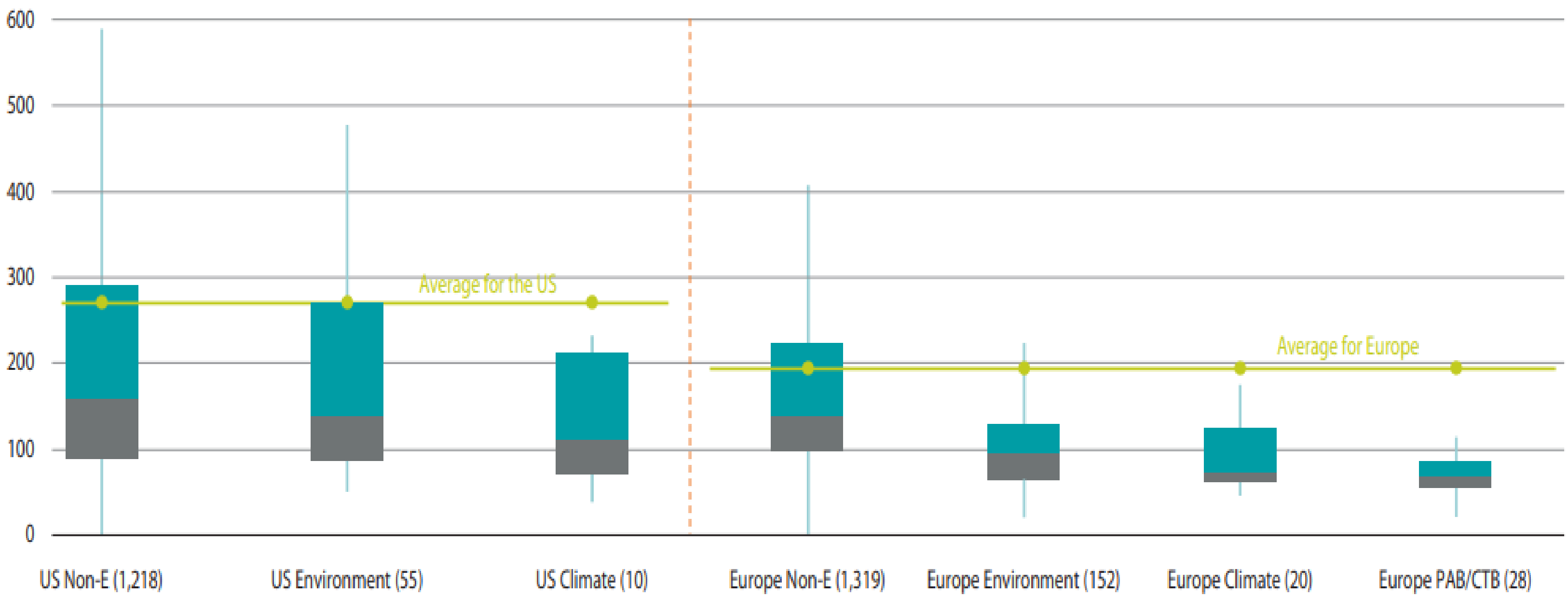
Other metrics

- Acknowledge climate risks
- Advocacy about climate policy action
- Climate planning
- Executive pay linked to transition targets
- Capex and climate targets
- Rewards act of disclosures
- Third party verification

Comparison of US and EU equity climate funds

- Dedicated climate funds have lower carbon intensity in Europe, particularly those aligned with Paris-aligned and climate transition benchmarks.

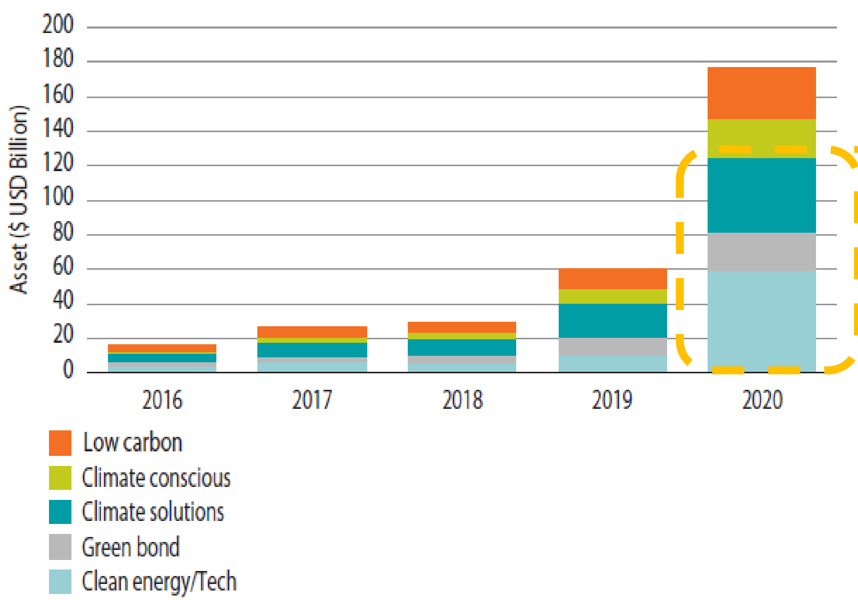
Graph 3.7 **Carbon intensity[1] statistics for various subgroups of index equity funds[2]**



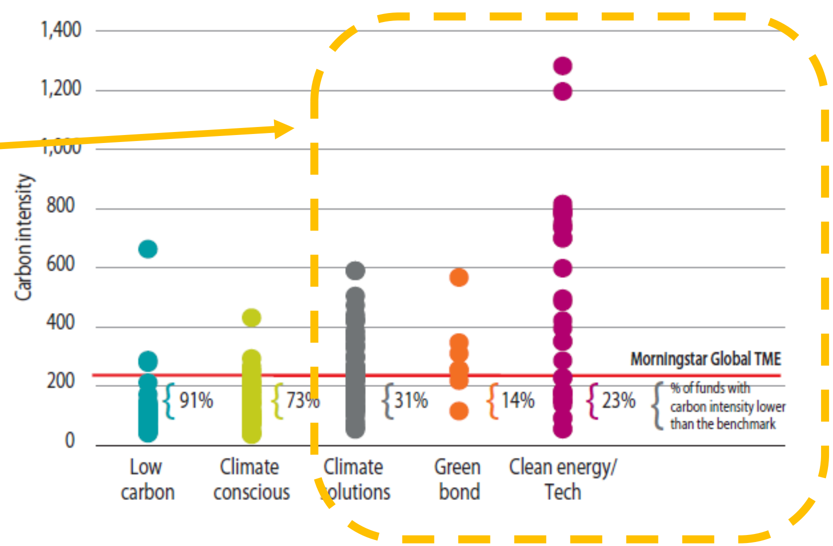
Growth of climate-aware funds

- Sharp growth of “climate aware” funds, which include a range of investment styles have risen x5 in several years.
- Yet, some investment styles – climate solutions, green bonds, and clean energy, have *much more carbon intensity* than typical funds.

Growth of “Climate Aware” Funds (assets by type)



***Carbon Intensity* by Type of Climate Aware Funds**



% = percentage of funds by AUM that are below the Morningstar Global Target Market Exposure

Key concerns with metrics, frameworks, and investment products

- Key commonalities across metrics should improve through TCFD guidance and ISSB global baseline reporting, yet ***significant differences* may remain**.
- Use of climate metrics in ESG ratings and climate frameworks varies widely, and this causes the ***lack consistency and comparability***.
- Growing evidence that the ***Environmental score of ESG is not well aligned with climate transition*.**
- Climate transition frameworks are evolving, and growing use of net zero targets is welcome. Yet, **they also tend to weigh factors, such as *awareness* and the *act of disclosure*, more heavily than *actions* to reduce carbon emissions and intensity.**
- Environmental/climate funds and ETFs in name vary significantly in practice, in terms of carbon intensity, raising ***concerns about "climate" labelling and impact***.
- In light of the NGFS survey of growing use among central banks, it is important that they better understand this range of metrics, frameworks and products, in terms of their use, benefits, and shortcomings.

Areas for further research

Ratings, Metrics and Frameworks

- How various metrics and frameworks align with climate transition (eg OECD, forthcoming)
- Transition targets, scores and credit ratings.

Market pricing of climate transition

- Market valuations and forward-looking climate metrics – targets and plans, R&D, products, execution of pathways, etc.
- Cost of capital and impact on new investments; differentials within industries of leaders and laggards.

Portfolio actions and flows

- Investor actions – portfolio rebalancing of major asset managers and institutional investors.
- Engagement actions vs divestment.
- Performance of high and low carbon “climate” funds.

ANNEX: POLICY OBSERVATIONS

Policy observations 1

Enhance market transparency surrounding green and transition objectives

- **Policy-makers and authorities should carefully assess and understand the tools that are available to achieve long-term climate objectives**.
- While current green taxonomies, external review and assessment, and climate transition metrics and frameworks have been primarily applied to fixed income products, **the rise of ESG practices and products within green equity investment strategies merit further assessment and scrutiny**.
- **Taxonomies and climate transition frameworks are most effective when they have clear objectives, and science-based net zero targets**.

Policy observations 2

Facilitate comparability and interoperability of taxonomies, frameworks and principles

- To avoid the risks that various green taxonomies, standards and principles lead to divergent outcomes, **enhance comparability and interoperability of taxonomies and transition frameworks**, in order to enhance a common understanding and provide a consistent basis for green external review.
- **External review, assessment, and engagement are key to market integrity**.
- **Due diligence in the assessment of climate risks by institutional investors** forms a sound basis from which to assess the credibility of issuer transitions.
- In the case of transition finance**, the transformation of the entity's business model is the critical purpose of funding, and entity-level analysis is essential**.

Policy observations 3

Strengthen future efforts on disclosure and reporting

- **Global baseline disclosure standards with industry specific activity metrics** form the basis for transparent, comparable and credible climate transition plans and climate investment products.
- The **minimum requirements** for sustainability reporting include both **forward-looking measures** necessary for transition metrics and **measurable sustainability performance indicators** for investors in order to verify whether forward-looking targets have been achieved.
- The **comparability of practices for calculating and reporting on environmental impact should be enhanced**.

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