



**Finance Watch**

Making finance serve society

# The problem lies in the net

How finance can contribute to making the world reach its greenhouse gas net-zero target

A Finance Watch report



**June 2022**



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**Acknowledgement:** We would like to thank the members of Finance Watch for their invaluable input and feedback as well as the numerous professionals and experts who contributed to this report by sharing their thinking and their experience.

**Cover photo:** Adobe stock / Melinda Nagy

**Graphics and typeset:** Camilla Dubois

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Finance Watch has received funding from the European Union to implement its work programme. There is no implied endorsement by the EU or the European Commission of Finance Watch's work, which remains the sole responsibility of Finance Watch.



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# Executive summary and main recommendations

## Executive summary

There is something dangerously wrong with the way we are applying the 'net' in net-zero. Net-zero is a radical and powerful idea for decarbonising our economies. But the fact that it is used to justify new fossil fuel developments when we know these are incompatible with the IPCC's target of limiting temperature increases to 1.5C tells us that something is off-track.

This report argues that the objective of the net-zero endeavour should not be to decarbonise financial portfolios or justify business as usual by non-financial companies; it must be to decarbonise the real world in time to avoid damaging and irreversible temperature increases.

Doing this will require aligning and correcting the way that 'net' emissions are counted and replacing today's over-optimistic focus on portfolio decarbonisation with more effective mechanisms, backed by regulation, through which the financial sector can push the non-financial sector towards carbon neutrality.

### Non-financial companies

To achieve net-zero in the economy, non-financial companies must become carbon neutral, which will need effective measurement and strong policy support. EFRAG, the SEC and ISSB are currently developing new sustainability standards for non-financial companies to enable that measurement, building on work done by the GHG Protocol, PCAF and TCFD. While it is unclear how these workstreams will interact or if they will be equivalent (for example only EFRAG plans to incorporate double materiality) several areas are emerging as critical to the debate:

- Measuring absolute GHG emissions, not GHG intensity. The intensity approach, as promoted by SBTi and many industry alliances, serves to dilute numbers and make targets easier to reach but it is the wrong metric. It allows financial portfolios to enjoy falling carbon intensity while financing more emissions in the real world. Since it is absolute emissions that will exhaust the planet's carbon budget, a truly science-based approach demands that absolute emissions be the key metric.
- Including scope 3 emissions in emissions disclosures. Scope 3 remains optional in SBTi and other disclosure frameworks and many companies choose not to disclose them. Yet these emissions are crucial for tracking progress to net-zero, especially in sectors such as energy and automotive, and regulators must ensure that, despite the technical aspects, they are counted.
- Excluding carbon offsets. Buying carbon offset credits is a way for companies to offload responsibility for their residual GHG emissions to parties outside their value chain. Given the difficulty of verifying the permanent sequestration of the carbon involved and the temptation for companies to use offsets as a licence to continue high-GHG emitting activities, we support EFRAG's proposal to exclude carbon offsets from net-zero accounting.
- Excluding avoided emissions. 'Avoided emissions' refers to the GHGs saved when a high GHG-emitting activity is replaced with a lower emitting one. While welcome in their own right, avoided emissions do not remove carbon and should not feature in net-zero accounting.

- Excluding hypothetical carbon dioxide removal. Carbon dioxide removal (CDR) techniques are highly uncertain: natural techniques such as afforestation may not be permanent, while as-yet-unscalable technological CDR would need to grow 40x from current levels by 2030, according to the IEA's NZE scenario. To keep companies' targets realistic, only currently existing CDR should be counted towards net-zero targets.

Once targets are set, companies need credible plans to achieve them. The EU has proposed a new duty for non-financial companies to publish transition plans. The proposal in Article 15 of the draft CSDDD is welcome but broad; it needs more details about the dates and targets in the plans, which should be linked to the EU's taxonomy for sustainable activities (and ideally the Extended Environmental Taxonomy proposed by the Platform on Sustainable Finance), as well as measures for supervision and enforcement.

### **Financial companies**

Within the financial sector, industry players have created a patchwork of net-zero alliances including NZAOA, NZAMI, NZBA, NZIA, NZICI, NZFSPA, PAII and GFANZ. Their objectives are sometimes conflicting - to save the climate, to save the value of financial portfolios, to profit from green growth – and they take different approaches to big questions such as whether to finance new fossil fuels or how to measure GHG emissions. This heterogeneity creates a risk of confusion and misleading claims about net-zero.

GFANZ represents trillions of financial assets and hundreds of financial institutions. As the leader in its space, it needs to look beyond market disclosure and single materiality and focus on reducing the financing of high GHG-emitting activities. A first step would be for its members to support stronger sustainability reporting, especially around the use of intensity targets, scope 3 emissions, carbon offsets, avoided emissions, and CO2 removal.

An early priority for net-zero alliances has been to decarbonise financial portfolios, in the hope that divestments will alter the cost of capital for GHG emitters and reduce real world emissions. While divestment from fossil fuel assets is possible and can exert a useful pressure, that is not the case for the rest of the economy. We argue that for structural reasons there is a limit to what the financial sector can achieve by trying to change its investing norms using tools such as portfolio decarbonisation and its sibling, portfolio alignment.

In today's portfolio management world, it is impossible to build very large carbon neutral investment portfolios. Simply put, this is because capital follows the economy, not the other way round. For active funds, replacing higher-GHG emitting investee companies with lower GHG-emitting ones will create increasingly large tracking errors that investment professionals are unlikely to accept. It also risks creating green asset bubbles. Passive funds that track sustainability-themed benchmarks can have limited real-world impact as long as their benchmarks rely on carbon-intensity metrics. Banks and insurers, for their part, have strong incentives to maintain market share and return on equity, which makes them unwilling to reduce current levels of financing for profitable but carbon-intensive activities. The presence of non-ESG investors who are willing (however unwisely) to hold high GHG emitting investments further limits the impact of divestment on real world decarbonisation. Sooner or later, such efforts to make mainstream investing diverge from a GHG-dependent economy will reach their limits.

However, financiers have another tool at their disposal: the power of stewardship. This requires financiers to retain at least some level of investment. Equity owners can influence non-financial companies through shareholder engagement, while lenders, insurers and private investors can influence companies by imposing conditions and covenants.

Shareholder engagements by investor coalitions such as Climate Action 100+, Say on Climate, As You Sow and Forum pour l'Investissement Responsable (FIR) have led to an impressive 69% of the world's highest emitters making net-zero commitments. But only 17% of those emitters have so far made a credible decarbonisation strategy. Climate-oriented engagement must therefore become more stringent and be associated with an obligation to obtain results. We recommend three measures to do this, which could be included in the upcoming review of the Shareholder Rights Directive (SRD II):

- (i) require ESG investors to publish their plans to engage investee companies;
- (ii) require ESG investors to vote against the management of investee companies that do not adopt and implement credible transition plans; and
- (iii) give supervisors a mandate to monitor climate-oriented engagement and enforcement powers over ESG investors.

In the banking, debt, private equity and insurance markets, participants have long imposed financial covenants to protect their interests. We argue that this should be extended to include climate covenants. Such covenants would link to the transition plans of customers and be mandatory for any financial service providers that claim an ESG, climate-oriented or net-zero status.

Climate covenants could include interim and final dates by when customers should have reached the 'substantial contribution' threshold established by the EU Taxonomy for their activity, with breaches leading to changes in pricing, coverage and other sanctions. The incentives and coercion that such a mechanism could provide would make net-zero transition an instant priority for non-financial companies and be a game-changer in the ability of financial institutions to decarbonise the real economy. The SRD II review is an opportunity to introduce climate covenant duties, for example by broadening the directive to cover other capital providers.

To bring these strands together, we propose a three-pronged approach in which no financial services should be marketed as 'ESG', 'climate-oriented' or 'net-zero' unless they fall into one of three categories: they relate to activities that are compliant with the EU Taxonomy, they are accompanied by a robust engagement plan, or they feature suitable climate covenants.

### **Supervisors' roles**

Several changes to supervisors' powers would be needed to implement the proposals above and the European Commission's Strategy for financing the transition to a sustainable economy has already pledged to give supervisors the means to address greenwashing. To implement this, we argue that supervisors' existing duties around information disclosure should be expanded to include climate-related information, both to protect investors from confusion about net-zero and to avoid build-ups of climate-related financial risk. For non-financial companies, supervisors will need powers to ensure that companies provide accurate information on their net-zero journey, which means counting absolute GHG emissions including scope 3, and not counting hypothetical carbon removal, carbon offsets or avoided emissions. They will also need powers to require

non-financial companies to disclose the transition pathways they used to create their plans, including intermediate targets every five years to 2050, and to impose sanctions for companies that fail to adopt or implement their plans.

For financial companies, supervisors will need powers to enforce the three-pronged approach described above, where financial services that claim an ESG, climate-oriented or net-zero status would have to be either fully taxonomy-compliant, involve a robust engagement plan, or include suitable climate covenants. Finally, there is a role for supervisors to control the quality, type and duration of carbon offsetting techniques, to avoid double counting of carbon credits, and manage the authorisation of certifiers.

### Conclusion

With only a few years remaining to stabilise atmospheric CO<sub>2</sub> at safe levels, the world economy remains strongly addicted to GHGs. Now is not the time to fool ourselves with loose definitions of net-zero or unrealistic hopes for portfolio decarbonisation. This report sets out some concrete ways that policymakers could drive progress to net-zero in the real world and direct the stewardship powers of the financial sector to the same end. The net-zero concept offers much to assist our journey to carbon neutrality, provided we define and use it well.

## Main recommendations

### For non-financial companies:

- “DOs” and “DON'Ts” of net-zero pledges of non-financial companies
- Include both final and intermediate targets and intermediate dates in transition plans
- Make the implementation of transition plans, not only their adoption, mandatory and enforceable

### For financial institutions:

- Make climate-oriented engagement systematic, impactful and enforceable
- Develop transition-linked financing and insurance
- Promote net-zero oriented financial products

### For supervisors:

- Supervise non-financial companies' carbon neutrality claims and transition plans
- Supervise financial institutions' net-zero claims
- Supervise carbon offsets certifiers

## As a way of introduction: (not so) anecdotal evidence

When it confirmed in April 2022 that it will go ahead with the contested US\$ 10 billion project to exploit, along with CNOOC, a new oil field situated at Lake Albert in Uganda, TotalEnergies said that the project was compatible with its climate objectives of reducing the carbon intensity of its products by 20% by 2030 compared to its 2015 level.

This means that the exploitation of yet more oil is compatible for TotalEnergies with reducing the carbon intensity of its products. It also ignores the call by the International Energy Agency to immediately stop all new fossil fuel investments for the world to reach net-zero by 2050.



TotalEnergies is telling us that **more greenhouse gas emissions are compatible with achieving its climate objectives and in particular reducing the carbon intensity of its products.**

In November 2021 in Glasgow, we heard the planet's major fossil fuel-producing countries gathered at COP 26 refuse to commit to reducing their production of oil, gas and coal and, at the same time, the Glasgow Financial Alliance for Net Zero (GFANZ), a coalition of 450 banks, asset owners and asset managers lining up a total amount of US\$ 130 trillion, announce a commitment to “bring together the financial sector to accelerate a transition to the net-zero economy”.



If we take Glasgow's declarations at face value, we are being told that **more greenhouse gas emissions are compatible with achieving net-zero.**

Over the past two years, three major multinational oil and gas companies BP, Total and Royal Dutch Shell have announced their plans to reach climate neutrality by mid-century.



Are they planning to stop exploring for more fossil fuels or are we being told that **more greenhouse gas emissions are compatible with achieving net-zero?**

On 6 April 2022, Canada's Federal Government approved a new oil project at Bay du Nord off the coast of Newfoundland on the premise that it would achieve net-zero greenhouse gas emissions by 2050.

To achieve this, Equinor, the oil company that will exploit the Bay du Nord project, will need to offset or capture the emissions produced using technology that has not yet been proven at scale. It also ignores the call by the International Energy Agency to stop immediately all new fossil fuel investments for the world to reach net-zero by 2050.



Canada's Federal Government and Equinor are telling us that **more greenhouse gas emissions are compatible with achieving net-zero.**

Since the COP 21 Paris Agreement in 2015, the major banking institutions of the world have provided US\$ 4.6 trillion of fossil fuel financing, despite their membership of several net-zero alliances and their commitment “to accelerate a transition to the net-zero economy”. By the same token, the banks in the scope of the Banking on Climate Chaos report 2022 that have committed to net zero by 2050 – 44 out of 60 – provided in 2021 US\$ 145.9 billion in financing for the 100 companies doing the most to expand oil, gas, and coal.<sup>1</sup>



GFANZ's and NZBIA's members are telling us that **more greenhouse gas emissions are compatible with achieving net-zero.**

<sup>1</sup> Rainforest Action Network et al; *Banking On Climate Chaos; "Fossil Fuel Finance Report 2022"; March 2022.*

With a view of clarifying the picture and deriving impactful action points, this report attempts to respond to a few essential questions: Has net-zero become the new buzzword for business as usual? Can net-zero be meaningful, or is it the biggest greenwashing concept ever invented? What does net-zero really mean? Can net-zero pledges achieve climate materiality? Under what conditions can net-zero make a difference? Can the financial sector contribute to making the world achieve net-zero and, if yes, how?



## I. Making net-zero meaningful and useful: what are we trying to achieve?

Saying that 'net-zero' is all over the place is an understatement.

The race to net-zero GHG emissions has arguably become over the past few years one of the hottest games involving the business world in the global effort to transition our currently unsustainable world towards sustainability. So much so that so-called net-zero alliances flourish everywhere and that the "Race to Zero" has become the brand name of a UN led campaign bringing together, in its own words, "a coalition of leading net zero initiatives, representing 1,049 cities, 67 regions, 5,235 businesses, 441 of the biggest investors, and 1,039 Higher Education Institutions".<sup>1</sup>

However, the debate over net-zero is riddled with ambiguity and misunderstandings. On the one hand, we can access and read thousands of pages of clever reports coming from dozens of organisations and alliances explaining how they contribute to making the world progress towards a net-zero situation, and on the other hand we hear greenwashing accusations, coming mainly but not exclusively from NGOs, pointing out the inconsistency of business organisations and alliances claiming that they are working for a net-zero world while continuing, and often increasing, their greenhouse gases (GHG) emitting activities.

The global warming situation is unfortunately well known: at today's pace of GHG emissions, the carbon budget of the planet, i.e. the amount of greenhouse gases mankind can afford to emit if it wants to limit global warming with an 83% probability below 1.5°, will be exhausted in 2030. The IPCC is also telling us that the greater global warming gets beyond 1.5° or 2°C, the more severe the impact on the planet will be. In other words, action is not only about not hitting the + 1.5° or the + 2°C thresholds but, as importantly, about limiting global warming as much as we can beyond those points.<sup>2</sup>

When it comes to GHG emissions, the world economy is in a situation similar to that of a man addicted to a poison and who, instead of quitting the poison on his doctor's advice, keeps taking it whilst also taking the antidote in the hope that the effects will cancel each other out. The antidote is what lies behind the word 'net' when we speak about 'net-zero' or 'net emissions': the world economy is so addicted to GHG, and in particular to carbon, that it wants to continue functioning by emitting as much as it can whilst offsetting its emissions. Is the world fooling itself by pretending that the antidote is effective? Can there be a sufficient amount of antidote of high enough quality to credibly outweigh the effects of the poison? In other words, can the notion of 'net-zero' be meaningful or should we simply quit emitting GHG altogether and aim for 'zero' as opposed to 'net-zero'?

With a view of assessing the role that financiers can play in the race to net-zero, the first question we need to ask ourselves is what we are trying to achieve when we set net-zero targets. Is the

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1 [United Nations Framework Convention on Climate Change, Race to Zero Campaign.](#)

2 In its April 2022 Working Group III report, [Climate Change 2022: Mitigation of climate change](#), the IPCC said that to limit warming to around 1.5°C, global greenhouse gas emissions would need to peak before 2025 at the latest and reduce by 43% from a 2019 baseline by 2030.

meaning of net-zero the same for the world in general, for the business world considered outside of the financial sector and for financial institutions? Is the objective of net-zero environmental? Is it financial? Is it a combination of both? Or is it environmental under financial constraints?

We will argue that the objective of net-zero is environmental but that it is constrained by financial considerations that need to be taken into account if we want to understand how the financial sector can contribute to reaching the objective.

The view taken by this report is that the objective of the 'race to net-zero' is to decarbonise the world, not financial portfolios. We will systematically take this view when we analyse the net-zero effort of the financial sector. We will look into what the financial sector can, or cannot, do to contribute to making the companies it finances, and thereby the world in general, reach net-zero. Decarbonising financial portfolios, if possible and useful, can only be a means to the end of decarbonising the world. This, in our view, is consistent with the function of finance as the enabler of economic activity, not as its ultimate goal.

### **What happened in Glasgow? A contradiction**

#### ***Glasgow's apparent paradox:***

A close look at the outcomes of the COP 26 that took place in Glasgow in November 2021 can help us to realise that ambiguities around the meaning of net-zero have given rise to misunderstandings at the heart of the net-zero debate.

We heard in Glasgow how the major fossil fuel producing countries of the world - USA, China, Russia, Saudi Arabia, Canada and Australia – had affirmed their refusal to commit to reduce, let alone stop, their production of oil, gas and even coal. At the same time, we heard the commitment by the 450 financial institutions and US\$130 trillion strong Glasgow Financial Alliance for Net Zero (GFANZ) to *“bring together the financial sector to accelerate a transition to the net-zero economy”* with a goal of *“achieving the objective of the Paris Agreement to limit global temperatures increases to 1.5°C from pre-industrial levels”*.

At first sight, the two affirmations seem difficult to reconcile: surely, there must be an incompatibility between governments announcing that they will continue to extract and burn ever greater quantities of fossil fuels, and therefore increase GHG emissions, and private financial institutions committing US\$ 130 trillion - an amount equal to roughly twice the size of the world GDP and bigger than the total market capitalisation of all equity markets - to the objective of reaching a global net-zero target. It seems difficult to make sense of a world where private entities (businesses) would build a world reaching net-zero while the governments of the largest fossil fuel producing countries of the world would continue to support increasing fossil fuel production.

Can both situations really co-exist?

An explanation sometimes heard to explain this apparent paradox is that the private sector would be so determined when it comes to combating climate change that it would be in a position to force governments to stick to the internationally agreed Paris Agreement.

Faced with a vital threat, private entities (financial institutions) would, according to this explanation, take control of the situation and assume responsibility for a public good (limiting GHG emissions in order to mitigate global warming) against the will, or at least the intention, of governments. This “private parties take control of public interest” explanation is highly doubtful not only because private parties rarely pursue a public interest objective without being forced to do so, but also because they would do so against the declared intentions of their governments, something even more difficult to believe.

A closer look at the situation shows that the paradox is only apparent. The paradox lies rather in the ambiguity that comes with ill-defined words: Governments refusing in Glasgow to commit to limit their fossil fuel extraction activities were implicitly refusing to limit their absolute levels of GHG emissions. Financial institutions gathered in GFANZ and making net-zero pledges were speaking about carbon intensity (i.e. the amount of GHG emitted per unit of production), not about absolute emissions. This distinction is all the more important in the case of GFANZ (and, as a matter of fact for all net-zero alliances of the financial sector) that seizing the business opportunities arising from the fight against global warming is one of its stated objectives: if tomorrow’s economic growth (i.e. the incremental part of economic activity) succeeds in being green while the currently existing part of the economy continues to be as carbon intensive as it is today, absolute GHG emissions will not decrease but GHG intensity of tomorrow’s economy will, and the world will move towards the net-zero objective that GFANZ has given itself, albeit with a debatable impact on climate change mitigation.

Glasgow’s real contradiction:

If Glasgow is guilty of one thing, it is of the obvious contradiction between the refusal, as above, of many governments to pledge to decrease fossil fuel production and the clear affirmation of the International Energy Agency contained in its ‘Net Zero by 2050’ roadmap released a few months before the COP 26 conference of the necessity of “*no new oil and gas fields approved for development*”, of “*no new coal mines or mine extensions*”, of “*the necessity of phasing-out unabated coal by 2030 in advanced economies*”, and of “*phasing-out all unabated coal and oil power plants by 2050*”.<sup>3</sup>

Contrary to the understandable, if undesirable, ambiguity of objectives between absolute emissions and intensity that led to the apparent paradox described above, this is a pure contradiction. When the above-mentioned countries refuse to phase-out fossil fuel production, including coal, they are in an obvious conflict with the International Energy Agency even if they pretend not to see it. Shutting one’s eyes on the basis of “real politik” does not remove the blatant contradiction.

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3 International Energy Agency - Net Zero by 2050 Report – A Roadmap for the Global Energy Sector, October 2021, Figure 4.1 Selected global milestones for policies, infrastructure and technology deployment in the NZE, page 152.

## II. Decarbonising the real world: the case of non-financial corporate issuers

It all starts with the real world.

After the different IPCC reports, there is no further need to describe why and how the world's carbon intensive economy feeds global warming nor what should be done to stop the human-induced climate change process: the global economy, and more specifically the world of business, has no choice but to change the way it operates if the global GHG neutrality target is to be reached.

Achieving the GHG neutrality of non-financial companies is the most important means to mitigate global warming.

This chapter looks at the conditions necessary for non-financial companies to target and achieve GHG neutrality, and the credibility and impact of their transition plans.

### → Conditions for non-financial companies' GHG neutrality to be possible<sup>4</sup>

- (i) First and foremost, companies must reduce their GHG scope 1, scope 2 and scope 3 emissions in absolute terms.<sup>5</sup>
  - ❖ Achieving absolute GHG emissions reductions is the key element here: the planet's carbon budget is, by definition, a question of absolute amounts and so is its exhaustion.
  - ❖ The intensity approach dilutes numbers, it makes them look better and it makes targets easier to reach, but it is the wrong metric. Anthropogenic global warming is a direct function of the tonnes of GHGs, and mainly CO<sub>2</sub>, emitted by human activities into the atmosphere, not of the proportion of their activities that emit GHGs.
  - ❖ The Science Based Target Initiative (SBTi),<sup>6</sup> which has imposed itself as the standard to assess businesses' net-zero targets, thinks, to a large extent, in terms of intensity, and not absolute emissions. In the context of SBTi's self-declared and very powerful science-based pretension, this means that its standards give a flawed vision of the real effect on climate change of corporate net-zero pledges. This is problematic given the wide recognition of its work by the international business community.
  - ❖ Despite methodological difficulties of measuring scope 3 emissions, taking them into account in one way or another is indispensable as they represent a considerable proportion, and for a number of sectors the majority, of total GHG emissions. Worryingly, a high proportion of SBTi-aligned businesses ignore scope 3 emissions today. For some sectors, this raises serious doubts about the usefulness of the notion of being 'SBTi-aligned'.

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4 This section takes inspiration, if not exclusively, from the October 2021 report of the Climate and Sustainable Finance Commission of French market regulator, Autorité des Marchés Financiers, '*Companies and carbon neutrality: initial conclusions and issues identified*'.

5 Scope 1 covers direct emissions from owned or controlled sources. Scope 2 covers indirect emissions from the generation of power consumed by the company. Scope 3 includes all other indirect emissions that occur in a company's value chain (upstream and downstream).

6 *Science Based Targets Initiative* (SBTi).

(ii) Secondly, companies can contribute to the removal and the sequestration of CO<sub>2</sub> out of the atmosphere.

- ❖ Carbon dioxide removal (CDR) can be done either via natural solutions (e.g. afforestation, reforestation, land management...) or technological solutions (carbon capture and storage (CCS), carbon capture, utilisation and storage (CCUS)) and their variations (direct air carbon capture (DAC), bio-energy with carbon capture and storage (BECCS)...).
- ❖ Natural solutions are the most efficient and cheapest way to remove carbon dioxide from the atmosphere but their capacity to keep it sequestered permanently is a delicate question as fires or the change of use of soils result in its release back to the atmosphere. The issue of land availability is also a major constraint that creates a scalability issue.
- ❖ On paper, technology seems to be the obvious solution but it faces a significant scalability challenge, which has not been resolved to this day. The volume of captured CO<sub>2</sub> currently stands at 40 MT per annum (i.e. 0.1% of the world's CO<sub>2</sub> emissions), but according to the IEA it must increase to 1,600 MT CO<sub>2</sub> in 2030 and 7,600 MT CO<sub>2</sub> in 2050 if we want to achieve a net-zero economy.<sup>7</sup> There is today a general agreement that without CDR, no net-zero economy will be achievable. However, there is also a wide recognition in the community of experts that going from an annual volume of CO<sub>2</sub> captured and sequestered permanently equal to 40 MT today to 7.6 GT in less than 30 years' time (i.e. increasing by a factor of 190) will be at best very challenging (most authorised voices call it unrealistic), in particular given that the challenge is not only about capturing CO<sub>2</sub> but also about transporting and sequestering it permanently. Counting on CDR and CCS technologies to be deployed on the scale we need them seems to be an act of faith when one considers that these technologies were in demonstration phase twenty years ago and they still are today.<sup>8</sup>
- ❖ Importantly, if not reassuringly, according to the IEA "reaching net zero by 2050 requires further rapid deployment of available technologies (scalability issue) as well as widespread development of technologies that are not on the market yet."<sup>9</sup>
- ❖ In summary, CDR and CO<sub>2</sub> sequestration solutions must be encouraged, but there are serious reasons to doubt that they will be sufficiently scalable to contribute meaningfully to achieving the 2050 net-zero target. There is clearly a paradox between the IEA's affirmation of the necessity of CDR and CO<sub>2</sub> sequestration solutions to achieve a net-zero world and the fact that no expert of the field seems to be able to affirm that those solutions will be developed at scale and fast enough to contribute in any significant manner to achieving net-zero.

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7 Under the IEA's Net-Zero Emissions by 2050 Scenario; see IEA: Net Zero by 2050 – A Roadmap for the Global Energy Sector - 2.5.7 Carbon capture, utilisation and storage, page 79.

8 See, for instance, Reclaim Finance: *The IEA's Net-Zero 2050*, December 2021, Box 6 page 17 "The CCS illusion".

9 IEA: Net Zero by 2050 – A Roadmap for the Global Energy Sector – Net zero by 2050 requires huge leaps in clean energy innovation, page 15.

(iii) Thirdly, companies can finance 'carbon offsetting' projects by purchasing 'carbon credits' on the voluntary market.

- ❖ Carbon offsets are a way to conduct CDR and CO<sub>2</sub> sequestration outside of the value chain of a particular company. The technical limitations of CDR and CO<sub>2</sub> sequestration described above apply even more acutely because they happen outside of the value chain, and therefore outside of the control, of the company setting net-zero targets.
- ❖ Carbon offsets must meet a number of minimum quality criteria to ensure that they correspond to projects that effectively reduce, capture or sequester emissions.
- ❖ In order to achieve that objective, authorised external verifiers must certify them.
- ❖ "Carbon credits" should under no circumstance be considered as a right to emit and cannot replace the effort to reduce absolute direct emissions.
- ❖ Given the fragility of the accounting and assessment processes for carbon credits, and the strong incentive for companies to bypass the mitigation hierarchy and treat carbon offsets as a 'licence to emit' instead of a last resort measure, carbon offsetting outside of the value chain should never be accounted for in the net-zero effort of companies nor in the determination of whether they have achieved their net-zero targets. Offsetting should be seen as the cherry on the cake and not mistaken for the cake itself.

(iv) Lastly, avoided emissions should be treated with great caution and under no circumstance as part of the net-zero endeavour of a company.

- ❖ Avoided emissions follow a 'could have been worse' logic. They are assessed in comparison with a baseline scenario and they are developed with the idea that the products or services sold by a particular company would have resulted in higher CO<sub>2</sub> emissions if they had been produced using more carbon intensive technologies (a rather tautological concept).

Avoided emissions are inherent to the green technology innovation dynamic described by the IEA as indispensable to reach a net-zero economy. 'Avoided emissions' is a positive concept as 'green innovation' leads to less CO<sub>2</sub> intensive production or consumption processes. However, its quantification is at best very fragile (the level of avoided emissions is by definition dependent on the baseline scenario contemplated) and difficult to interpret as it consists of focusing on the avoided part of the equation while forgetting to count the (still) real emissions. For instance, if a coal-powered plant emitting 1000 g of CO<sub>2</sub> to produce 1 KWh of electricity is replaced by a gas-powered plant emitting 400 g of CO<sub>2</sub> to produce 1 KWh of electricity, the calculated avoided emissions will be  $(1000 - 400) = 600$  g of CO<sub>2</sub> per KWh produced, conveniently overlooking that 400g of CO<sub>2</sub> emissions were still added when producing 1 KWh of electricity by burning gas.

**“DOs” and “DON’Ts” for net-zero pledges of non-financial companies to be considered as material from a climate perspective**

DOs	DON’Ts
<ul style="list-style-type: none"> <li>• Consider absolute GHG emissions, not GHG intensity;</li> <li>• Account for all scope 1, 2 and 3 emissions;</li> <li>• Take into account only existing, as opposed to hypothetical, carbon dioxide removal (CDR) combined with existing permanent sequestration techniques effectively counter-balancing today, at the scale required and reported, their own GHG emissions;</li> </ul>	<ul style="list-style-type: none"> <li>• Do not consider purchased carbon offsets in carbon neutrality assessments;</li> <li>• Do not consider avoided emissions in carbon neutrality assessments.</li> </ul>

**→ Making non-financial companies’ transition plans credible and impactful**

Article 15 of the proposed EU Directive on corporate sustainability due diligence (CSDDD)<sup>10</sup> contains an obligation for companies in the scope of the Directive to “*adopt a plan to ensure that {their} business model and strategy {...} are compatible with the transition to a sustainable economy and with the limiting of global warming to 1.5 °C in line with the Paris Agreement. This plan shall, in particular, identify, on the basis of information reasonably available {...}, the extent to which climate change is a risk for, or an impact of, the company’s operations.*” Article 15 also states that “*in case climate change is or should have been identified as a principal risk for, or a principal impact of, the company’s operations, the company includes emission reduction objectives in its plan*”.

If Article 15 CSDDD has a good intention and considers rightfully both financial and environmental materiality, it is also characterised by its vagueness and the lack of detail of the envisaged plans. This is a major problem as, absent concrete prescriptions, we can rest assured that the plans considered will not achieve the stated objective of “*the limiting of global warming to 1.5 °C in line with the Paris Agreement*”.

In order to make them meaningful and impactful, the transition plans considered by Article 15 of the CSDDD should be based on the EU Taxonomy for sustainable activities, and more precisely on the technical screening criteria established by the Delegated Act for its climate change mitigation

<sup>10</sup> European Commission - Proposal for a Directive of the European Parliament and of the Council on Corporate Sustainability Due Diligence and amending Directive (EU) 2019/1937; February, 2022. [Brussels, 23.2.2022 COM\(2022\) 71 final 2022/0051 \(COD\)](#).

objective.<sup>11</sup> This would have the triple advantage of founding the mechanism on solid ground, of enabling supervisors to control the process and of enhancing the role of the EU Taxonomy for sustainable activities as a tool to foster the transition of the economy towards sustainability, and in this particular instance towards net-zero.

Using this reference to define transition plans would not only establish definitely the Taxonomy as the transition tool we need it to be, but it would also bring the necessary rigour to transition plans that have otherwise a high chance of remaining vague or seeing companies give themselves complacent objectives. One possible option would be to consider the proposal made by the Platform on Sustainable Finance on an Extended Environmental Taxonomy.<sup>12</sup> Despite the additional complexity that would come with such an extended Taxonomy, this would have the benefit of bringing granularity to issuers' and investors' approaches to sustainability by distinguishing between “*unsustainable performance requiring an urgent transition to avoid significant harm*”, “*intermediate (or amber) performance*”, “*unsustainable, significantly harmful performance where urgent, managed exit/decommissioning is required*” and “*low environmental impact activities*”. It remains to be seen at this stage whether the European Commission will decide to convert the report produced by the Platform on Sustainable Finance into a legislative proposal.

In any case, the CSDDD should be amended to ensure that companies include in their transition plans the following minimal provisions:

- A target date by which companies would commit to having reached the ‘substantial contribution’ threshold established by the Taxonomy technical screening criteria for its field of activity;
- Intermediate dates with intermediate targets on the way to reaching the final ‘substantial contribution’ threshold;
- Making the implementation of transition plans, not only their adoption, mandatory;
- Giving a mandate to supervisors to enforce the adoption and the implementation of companies’ transition plans.

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11 [Official Journal of the European Union](#) - Commission Delegated Regulation - (EU) 2021/2139 of 4 June 2021 supplementing Regulation (EU) 2020/852 of the European Parliament and of the Council

12 Platform on Sustainable Finance - [The Extended Environmental Taxonomy – Final Report on Taxonomy extension options supporting a sustainable transition](#), March 2022.



### III. Decarbonising financial portfolios or decarbonising the real world?

This chapter looks at the strengths and weaknesses of net-zero alliances and current efforts to decarbonise financial portfolios. By 'decarbonising financial portfolios', we mean efforts by the financial sector to shift investments for the wider economy from higher to lower carbon assets. We argue that this approach has structural limits and will not significantly reduce real world GHG emissions.

Divestment campaigns focussed on fossil fuels, an outside-in approach whose success depends on activists pressurising investment managers to diverge from investment norms, are a separate strategy which brings its own benefits and is not explored here.

The limitations of decarbonising portfolios through carbon accounting techniques were covered in Chapter II. Decarbonising through engagement and stewardship, which we believe could become a highly effective tool for decarbonising the real economy, will be covered in Chapter IV.

#### → Decrypting the objectives of net-zero alliances

The financial sector has seen over the past few years a flurry of net-zero alliances being established. On the back of the demands expressed over the years in the various COP conferences, of intense civil society pressure and of regulators' calls for the financial sector to look into the financial risks arising from climate change, financial institutions of all kinds, asset owners, asset managers, bankers, insurers, investment consultants, have come together to create so-called net-zero alliances:

Net-Zero Asset Owners Alliance: [NZAOA](#)

Net-Zero Asset Managers Alliance: [NZAMI](#)

Net-Zero Bankers Alliance: [NZBA](#)

Net-Zero Insurance Alliance: [NZIA](#)

Net-Zero Investment Consultants Alliance: [NZICI](#)

Net-Zero Financial Services Providers Alliance: [NZFSPA](#)

Paris Aligned Investment Initiative: [PAII](#)

Glasgow Financial Alliance for Net Zero: [GFANZ](#)

With such a broad momentum in the same direction, the financial sector seems to be demonstrating its eagerness to act towards contributing to build a net-zero world, or at least to show that it is acting for that purpose. However, the emerging landscape is patchy. If the mere existence of those alliances sends a signal that the net-zero issue is now high on financial institutions' agenda, an analysis of their policies, their letters of commitment, the work they are doing and the methodologies they are following leaves a sense of dispersion that makes an assessment of their contribution anything but straightforward:

- They line-up an impressive number of dozens of trillions of dollars of assets in a bid to show how committed the financial sector is to save the world.
- They develop, thanks to the numerous working groups they convene, an important technical reflection to define the principles that could or should underlie net-zero.

- Their approach to making their respective sub-segments of the financial sector net-zero is a combination of three dimensions:
  - ❖ a ‘save the world’ dimension aiming to limit global warming to 1.5° in line with the COP 21 Paris Agreement.
  - ❖ a ‘save the value of my financial portfolio’ dimension trying to limit the negative impact of global warming on businesses’ accounts and profitability.
  - ❖ a ‘seize the opportunity’ dimension emphasising the business perspectives coming with the global effort to green the world economy.
- Their objectives are not all aligned with one another nor necessarily based on a similar approach. For instance, the NZIA’s commitment letter is the only one among the various net-zero alliances to refer to the International Energy Agency’s (IEA) *Net Zero by 2050* report,<sup>13</sup> something not indifferent given the injunction of the report to stop immediately all investments in new fossil fuel reserves, to phase-out unabated coal by 2030 and all unabated coal and oil power plants by 2050.
- They all leave the latitude, either de jure or de facto, to assess net-zero targets on the basis of the absolute level of emissions or on an intensity basis.
- They tend to encourage the inclusion of scope 3 in the measurement of GHG emissions (with the exception of NZAOA) but they add provisos along the lines of “*where significant, and where data allow*” (NZBA and NZIA) or “*to the extent possible, material portfolio Scope 3 emissions*” (NZAM), effectively allowing the institutions signing the commitments not to include scope 3 emissions if they wish not to (and most of them do not). Interestingly, Climate Action 100+<sup>14</sup>, whose members overlap to a large extent the members of NZAOA and NZAM, takes a rather ambiguous approach to scope 3 emissions, stating in its “Benchmark” indicator 5 – decarbonisation strategy (sub-indicators 5.1a and 5.1b) that the measures should include scope 3 emissions “*where applicable*”, which could leave the door open to diverse interpretations and subsequently to incoherent standards between reporting entities.
- They may be more or less prescriptive with their members on what achieving net-zero implies for them, but in the end they each function like a club of apparently like-minded people with the intention of rowing in the same direction but with little internal discipline to effectively do so. This is, for instance, the case for the central issue of determining whether decarbonising a financial portfolio should focus on portfolio GHG intensity or the absolute level of emissions. NZBA is notorious for its relatively lax level of prescriptiveness as opposed to NZAOA, which is on paper more prescriptive but shuts its eyes when members choose not to apply its prescriptions (NZAOA states that emission reductions should be achieved in absolute terms, but up to 90% of its members seem to express their emission reductions as an intensity...). By the same token, on the subject of portfolio alignment, NZAOA’s self-proclaimed ‘model agnosticism’ implies that its members can choose the model they want to move along the decarbonisation pathway, and this leaves a lot of space for uncoordinated and possibly inconsistent trajectories or logics of portfolio construction.

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13 International Energy Agency - “Net Zero by 2050 Report – A Roadmap for the Global Energy Sector, October 2021.

14 Climate Action 100+ - [List of Investor Signatories](#)

The points made here do not constitute an exhaustive analysis of the financial sector net-zero alliances, but they reflect the fact that very different realities and degrees of commitments underlie the nice ‘net-zero’ headlines and that an external observer would be mistaken to think that the same words correspond to the same realities, whether between the various alliances or even within the alliances themselves. This makes for a ‘net-zero ecosystem’ that is both heterogeneous and complex to apprehend.

By announcing in Glasgow that it had lined-up US\$ 130 trillion to achieve net-zero, GFANZ, which can be described as the alliance of the other financial industry net-zero alliances, has become the star of the sector. In an implicit recognition of the importance of headline figures to grasp media attention, GFANZ is adding chunks of money of different natures (\$ 67 trillion of assets invested on the one hand and \$ 63 trillion of banks’ assets on the other)<sup>15</sup> and is most probably double-counting significant amounts of invested money by adding \$ 57 trillion of asset managers’ money and \$ 10 trillion of asset owners’ money. However, beyond the fact that GFANZ’s headline firepower number may not stand up to close scrutiny, the importance of the alliance is reflected in the number of financial institutions, 450 altogether, that have decided to join. Surely, 450 financial institutions deciding to join forces to achieve net-zero is something to be reckoned with.

The question we have to ask ourselves when looking at GFANZ is whether it has given itself the means to reach its objectives.

GFANZ puts a particular emphasis on the risks and opportunities, in other words the business dimension, underlying the net-zero objectives. This is coherent with the vision that Mark Carney, who is chairing GFANZ, has developed since his famous “tragedy of the horizons” speech in 2015 and throughout the work he has led with the Task Force on Climate-Related Financial Disclosure (TCFD), all of which have been centred on financial materiality, both in its risk and opportunity dimensions, and on the underlying (in our view extremely optimistic, not to say unrealistic) assumption that bringing the right information to capital markets will be sufficient to change the behaviour of economic actors.<sup>16</sup>

The alliance’s focus on the opportunity side of the equation is reflected in Mark Carney’s comment that in GFANZ “we have all the money needed”. Indeed, with an estimated investment need of \$ 125 trillion “to transform our economy and avoid the worst physical impacts of climate change”,<sup>17</sup> GFANZ seems to have all the money needed, notwithstanding the fact that it is most unlikely that 100% of the money invested or lent by the 450 member institutions of GFANZ can be dedicated to this sole objective, and notwithstanding the double-counting necessary to arrive at the US\$ 130 trillion figure.

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15 Asset owners and asset managers manage ‘existing money’, whereas banks create money through their lending activity as summarised by the adage “loans make deposits”.

16 Policymakers’ views of TCFD need to evolve from being a standalone market fix to seeing it as one of a sequence of policy interventions that build on each other. TCFD has had the immense merit of raising awareness on the financial materiality of climate change and of starting to generate data, which are indispensable steps towards developing Transition Plans. TCFD is a necessary but not sufficient condition for change, it is a stepping stone.

17 Glasgow Financial Alliance for Net Zero - [Financing Roadmaps](#)

As evidenced by the interview given to Bloomberg on 26th April 2022 by its Chair<sup>18</sup> and by the fact that its signatories have provided US\$ 4.6 trillion of fossil fuel financing since the COP 21 Paris Agreement in 2015 and US\$ 742 billion in 2021 alone,<sup>19</sup> one thing GFANZ is not about is reducing the financing that its members bring to high GHG emitters or sources of GHG emissions. GFANZ's view of contributing to make the world reach its net-zero target is based on financing the 'green' investments necessary to build a less carbon intensive economy, on counting GHG emissions on an intensity basis (as already seen, compatible with no reduction of absolute emissions) and on not being too rigorous when it comes to GHG emissions reporting, either thanks to flexible metrics policies (e.g. for counting scope 3 emissions) or by including offsets, avoided emissions, and sometimes CDR hypotheses based on not yet deployed technologies when calculating the 'net' in 'net-zero'. In any case, its lack of prescriptiveness leaves its members a lot of latitude to adopt the standards that suit their particular case, with the consequence that those standards are not all coherent with one another. The lack of clarity of the resulting situation is compounded by the large number of GFANZ members and the variety of their characteristics. This makes not only for a patchy landscape, but also for a net-zero headline that some might consider as misleading for an external observer that would not be equipped to analyse the detail.

### → Theory of change underlying the decarbonisation of portfolios: a fairy tale of asset allocation influencing the world

As the net-zero alliances develop their work, much effort is being put into the decarbonisation of financial portfolios. This section looks at the divestment mechanisms currently in use and explores why this approach can make only a limited contribution to making the world carbon neutral.

The theory of change behind the decarbonisation of financial portfolios has the appearance of compelling logic: the decarbonisation of financial portfolios, i.e. of investment portfolios and banks' lending books, is supposed to starve high GHG emitters from easy access to the capital they need, to subsequently increase their cost of capital and, thereby, create a momentum that will force the transition towards a decarbonised economy. If operationally different, the theory of change of the decarbonisation of insurance underwriting portfolios has a similar logic as insurance coverage is necessary to operate and raise finance and the lack of it would contribute to starving high GHG emitters from easy access to capital.

Beyond the resistance to be expected against a theory of change that would mean less profit in the short term for financiers and high carbon emitters (as too well known, we live in a world where profits and rewards are assessed on a short-term time horizon), this theory of change has to be tested against hard facts and technical reality: can the decarbonisation of financial portfolios be the means to decarbonising the world?

Answering this question requires looking at the question from three angles: 1) How can the decarbonisation of a financial portfolio be technically achieved? 2) How is the decarbonisation of financial portfolios measured? 3) Can the decarbonisation of financial portfolios lead to a decarbonisation of the world?

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18 *In this interview* with Bloomberg Green Finance's Alistair Marsh, Mark Carney said in a candid, and as such welcome, assertion that expecting banks to eliminate all financing of carbon intensive industries was "unrealistic" and he expressed the wish to see Chinese banks, by far the biggest lenders to the coal sector, join GFANZ. Mark Carney's interview confirmed implicitly in passing the notorious push-back of GFANZ against the recommendation made by the IEA in its 'Net Zero by 2050' report to stop immediately any investment in new fossil fuel reserves.

19 Rainforest Action Network, *Banking On Climate Chaos: "Fossil Fuel Finance Report 2022"; March 2022*

## 1. How can the decarbonisation of a financial portfolio be technically achieved?

### The case of investment portfolios:

As pointed out by a number of high-level research papers, in particular Le Guenedal et al.<sup>20</sup> and Bolton et al.<sup>21</sup>, and despite the different and sometimes diverging conclusions they draw (we will outline those differences below), decarbonising an investment portfolio is relatively easy to achieve thanks to well established financial engineering techniques. Describing those techniques in detail is beyond the scope of this report and better left to academics and financial engineers, but in essence they can be boiled down to a portfolio optimisation exercise achieved by excluding the highest GHG emitting companies in order to minimise the portfolio's carbon footprint whilst minimising its tracking error<sup>22</sup>. Put differently, in order to decarbonise an investment portfolio, invest as little as possible in high GHG emitting companies, replace them with low GHG emitting companies and minimise the possible divergences of performance between the portfolio and its benchmark.

In the world of investment management, the tracking error is considered as the relevant measure of risk. We will come back to this question as it has many consequences and we will see that this technical factor is key to analysing the possibility of developing decarbonised investment portfolios on a large scale.

### The case of banks' loan books:

If decarbonising an investment portfolio is a relatively straightforward process within the limit imposed by the tracking error, decarbonising a bank's loan book is conceptually even simpler. As a bank's loan book is not subject to a tracking error constraint, decarbonising is simply a function of a business decision to decrease the amount of financing provided to the carbon intensive part of the economy.

If conceptually simple, the decarbonisation of banks' loan books is confronted in the real world with the fact that banks see their mission as 'financing the world as it is'. Even if banks are free to choose which companies and which sectors they want to do business with, they operate under a double constraint of market share and of return on equity maximisation, which effectively leads them to pursue all possible business opportunities offering the right financial risk-reward profile. This constraint, if expressed as a principle and not mathematically, is the equivalent of the tracking error applying to the investment management world: allocating capital away from the mainstream economy, in other words diverging from the world as it is, is something that financiers, whether investors or bankers, either do not know how to do, or do not want to do.

## 2. How is the decarbonisation of financial portfolios measured?

The way the decarbonisation of portfolios is measured is of the utmost importance if we want to make sense of the various net-zero pledges and claims of financial institutions.

A lot of thorough technical work has been done on the reporting side, among which the GHG Protocol,<sup>23</sup> PCAF's Global GHG Accounting and Reporting Standard for the Financial Industry<sup>24</sup>

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20 LE GUENEDAL, T and LOMBARD, F and RONCALLI, T and SEKINE, T, Net Zero Carbon Metrics; February, 2022.

21 BOLTON, P; KACPERCZYK, M; SAMAMA, F - Net-Zero Carbon Portfolio Alignment, Financial Analysts Journal; March 2022.

22 The tracking error measures the deviation of the performance of an investment portfolio relative to the performance of its benchmark.

23 [Greenhouse Gas Protocol](#); Web page.

24 [PCAF - Partnership for Carbon Accounting Financials](#); Web page.

and TCFD's Portfolio Alignment Team<sup>25</sup> have a special place.

The work being done at the time of writing this report by EFRAG,<sup>26</sup> by the ISSB<sup>27</sup> and by the SEC<sup>28</sup> to develop sustainability reporting standards is essential as, once finalised, it define draw the landscape of net-zero reporting for the foreseeable future. It will decide what sustainability-related information will be at the disposal of investors, stakeholders, regulators and policy-makers and, in turn, allow them, or not, to make informed decisions.

Importantly, and sometimes overlooked in debates, reporting standards do not have the role of deciding which criteria should be taken into account in policy or business decisions. They have an 'information provider' function. Sustainability reporting standards do not make policy choices: their 'raison d'être' is to provide the information necessary to make informed decisions. Reporting standards are a toolbox, and having the most comprehensive and accurate sustainability reporting standards possible is tantamount to having as complete a toolbox as possible. How the tools are used is another story.

In coherence with the entire EU sustainable finance logic, EFRAG's logic founded on double materiality (i.e. combining inside-out impact materiality and outside-in financial materiality) is by construction more comprehensive than ISSB's and SEC's logics, which rely to a large extent on outside-in financial materiality.<sup>29</sup> Beneath the divergence of logic between the European sustainability reporting standards (ESRS) developed by EFRAG, the standards developed by the ISSB (which likes to call them 'international' for tactical reasons) and the American standards developed by the SEC, lies a usability question related to how reporting entities should, and can, deal with several reporting standards and whether one standard can encompass the others. The technical and geopolitical debate underlying this usability question is still open and will certainly remain so for some time.

With a view of grasping the essence of the net-zero debate, we highlight below a non-exhaustive insight into what we see as the most important debates on the measurement of GHG emissions:

(i) GHG intensity vs. GHG absolute emissions:

The fundamental question underlying the GHG intensity vs. absolute emissions debate is whether a future world with a very low or zero GHG intensity but absolute GHG emissions unchanged from today can meaningfully be called net-zero, or transitioning towards net-zero. Unfortunately, we know that global warming is fed by absolute GHG emissions, not by the GHG intensity of the world economy. The carbon budget of the planet is eaten, year after year, by the world's absolute GHG emissions, and absolute emissions are the only objective worthy of our attention if we want to mitigate human-induced global warming.

Despite this evidence, the intensity logic prevails over the absolute emission logic among financial institutions when they look into decarbonising their portfolios. This is explained by the difficulty of

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25 [TCFD - Measuring Portfolio Alignment – Technical Considerations](#); Web page.

26 [EFRAG - European Financial Reporting Advisory Group](#); Web page.

27 [ISSB - International Sustainability Standards Board](#); Web page.

28 SEC consultation, March 2022, '[The Enhancement and Standardisation of Climate-Related Disclosures for Investors](#)'.

29 As described in section 2. ii below, the SEC's approach does incorporate some elements of environmental materiality, but this is far too limited to make it an environmental sustainability reporting standard.

decarbonising portfolios in a highly carbon intensive world: most practitioners consider reaching a net-zero target measured on an intensity basis as ambitious enough, whilst reaching net-zero measured on absolute levels of financed emissions is seen by many as impossible given the reality of the world.

The practice is widespread, witness the fact that in its *Financial Sector Science-Based Targets Guidance*,<sup>30</sup> SBTi states that “financial institutions are also mitigating their climate impact by measuring emissions intensity of their portfolios”, adding that “the emissions intensity approach calculates emissions per economic unit”.

This is the reason why supposedly decarbonised financial portfolios are so often synonymous with stable, and even higher, absolute levels of financed GHG emissions. This is also one of the greatest apparent paradoxes of net-zero financial portfolios and, without doubt, one of their least understood features: the generalised use of intensity as a metric for the decarbonisation of investment portfolios has the consequence that an investment portfolio moving towards net-zero can see its overall level of absolute emissions increase whilst its GHG intensity diminishes. This is also true of banks’ net-zero loan books and it raises both the question of the climate materiality of net-zero financial portfolios constructed using an intensity measure, and of their financial materiality, for instance when it comes to managing the risk of loss linked to stranded assets.

The intensity vs. absolute emissions debate must be approached both from a principles standpoint and from a measurement standpoint.

Principles-wise, common sense tells us that achieving net-zero is a question of taming absolute emissions, not of decreasing the emissions intensity of the growing global economy. Put simply, the planet’s carbon budget will be exhausted by absolute emissions and this is the issue we are trying to address when we aim for net-zero.

Despite their different methodologies, the above-mentioned research papers by Le Guenedal et al. on the one hand and Bolton et al. on the other both reach, at least implicitly, the same conclusion: decreasing portfolio GHG intensity is technically compatible with stable and even increasing absolute emissions, and the objective should therefore be to decrease absolute emissions, not emissions intensity if we want net-zero to be meaningful.

From a measurement standpoint, the debate between GHG absolute emissions and GHG intensity is not binary as there are several ways of measuring intensity. This creates the possibility for financial institutions to pick the metrics that suit their purpose when they measure, and subsequently report on, intensity-based net-zero targets.

Table 2.1, page 23 of PCAF’s Global GHG Accounting and Reporting Standard for the Financial Industry shows that different metrics can be applied to measure portfolios’ emissions and that those different metrics effectively measure different realities from which different conclusions can be drawn. It also provides an implicit explanation of a lot of the misunderstandings surrounding the net-zero debate. A lot of the difficult debates around the achievement, or the non-achievement, of net-zero targets find their origin in the lack of common, or at least well described and understood, definitions and metrics.

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30 Science Based Targets Initiative (SBTi) - *Financial Sector Science-Based Targets Guidance; Version 1.0*. February, 2022, page 23.

Table 2.1: Financed emissions metrics

Metric	Purpose	Description
Absolute emissions	To understand the climate impact of loans and investments and set a baseline for climate action	The total GHG emissions of an asset class or portfolio
Economic emissions intensity	To understand how the emissions intensity of different portfolios (or parts of portfolios) compare to each other per monetary unit	Absolute emissions divided by the loan and investment volume, expressed as tCO <sub>2</sub> e/€M invested
Physical emissions intensity	To understand the efficiency of a portfolio (or parts of a portfolio) in terms of total carbon emissions per unit of a common output	Absolute emissions divided by an output value, expressed as tCO <sub>2</sub> e/MWh, tCO <sub>2</sub> e/ton product produced
Weighted average carbon intensity (WACI)	To understand exposure to carbon-intensive companies	Portfolio's exposure to carbon-intensive companies, expressed as tCO <sub>2</sub> e/€M company revenue

Source: Global GHG Accounting and Reporting Standard for the Financial Industry

(ii) Inclusion of scope 3 emissions:

There is a broad consensus on the fact that scope 3 emissions should be included in order to reflect the reality of businesses' GHG emissions. However, there is also a broad recognition that measuring scope 3 emissions is still work in progress and cannot be done on the basis of a universally accepted methodology. This, in turn, converts into a wide practice of non-inclusion, or of reporting with relaxed standards, of scope 3 emissions in businesses' reported GHG emissions.

This phenomenon is particularly obvious when we look closely at the way most financial sector related net-zero alliances, but also the Science Based Target Initiative, approach the issue: they all affirm the importance of including scope 3 emissions,<sup>31</sup> and shut their eyes, or even prepare the ground through appropriate wording, to the fact that the bulk of their members (probably up to 90% according to informal exchanges with professionals involved in the process) do not take them into account. In its *Financial Sector Science-Based Targets Guidance*,<sup>32</sup> the SBTi goes as far as saying that "it is recommended but not required for financial institutions to measure and set target(s) on categories 1–14 emissions as defined by GHGP Scope 3 standard" and that "financial institutions may consider setting absolute targets in line with a less ambitious 2°C scenario given that scope 3 emissions can be more difficult to reduce as compared to scope

31 See, for instance, Guiding Principle 1 in SBTi's *Foundations for science-based net-zero target setting in the financial sector*; April 2022.

32 Science Based Targets Initiative (SBTi) - *Financial Sector Science-Based Targets Guidance*; February 2022; page 93.



*1 and 2 emissions*". If this will make reporting look as good as possible, one might also argue that it will make it misleading.

The SBTi<sup>33</sup> proposes that scope 3 emissions should be reported only if they represent more than 40% of an issuer's emissions. Given the obvious necessity to calculate all GHG emissions, including scope 3 emissions, to determine whether the latter represent more or less than 40% of total emissions, the choice to allow the absence of reporting with such a high threshold could be seen as an attempt to flatter GHG emission reporting, in other words of making the picture look rosier (or greener!) than it really is. Inevitably, the picture of GHG emissions that will emerge from this low level of ambition will not be comprehensive.

Companies claiming to be net-zero and SBTi-aligned may, in reality, be under-disclosing up to 40% of their scope 3 emissions.

The landscape of scope 3 emissions will depend to a large extent on the sustainability reporting standards considered. For instance, whilst the European Sustainability Reporting Standards that EFRAG is developing call on companies to disclose scope 3 emissions that are material from a double materiality standpoint (as a matter of principle, scope 3 emissions are material from an impact materiality standpoint whilst the case is less obvious from a financial materiality standpoint), the SEC is currently proposing the disclosure of scope 3 emissions "that overall are material", but "material" in the SEC context most probably means "financially material" (even if there remains an ambiguity). Whether this leads to the under-reporting of scope 3 emissions will depend on how the SEC defines "materiality" once its consultation is finished. Once again, different realities lie behind the same words.<sup>34</sup> In any case, the picture emerging from the application of different sustainability reporting standards will be different and will have to be treated with attention by stakeholders before they are interpreted.

(iii) Offsetting and carbon removal techniques:

EFRAG and ISSB take different approaches to the reporting of carbon offset and carbon removals. EFRAG does not allow carbon offsets to count towards GHG emissions reduction targets, while the ISSB allows offsets to be counted and does not give any specific guidance. For carbon dioxide removal, both EFRAG and ISSB allow CDR to count towards GHG emissions reduction targets but EFRAG says only under specific conditions. The consequence is clear: the recommendations made in this report<sup>35</sup> are compatible with the sustainability reporting standards developed by EFRAG but not with those from the ISSB, not least because the ISSB standards (at least in the version currently proposed) include carbon offsets in companies' GHG reporting.

A picture emerges where a stakeholder's judgement of whether a company is achieving its net-zero targets may depend more on which sustainability reporting standards are used than on the reality of the company's contribution to climate change. Given the differences, not to say the divergences, between ESRS and ISSB standards, there can be no room for a naïve reading of net-zero achievements. If they are to reflect reality, claims of net-zero achievements must be defined within a precise reporting framework.

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33 Science Based Targets Initiative (SBTi) - *Financial Sector Science-Based Targets Guidance*; February 2022; page 32.

34 *Securities and Exchange Commission*, March 2022, page 174.

35 See "DOs" and "DON'Ts" for net-zero pledges of non-financial companies to be considered as material from a climate perspective.

### **3. Can the decarbonisation of financial portfolios lead to a decarbonisation of the world?**

In order for investment portfolios' net-zero efforts to be material from a climate standpoint, their decarbonisation should be done at a sufficient scale to modify investee companies' access to capital and thereby influence their behaviour.

In their paper published in March 2022,<sup>36</sup> Bolton et al. make an important statement that deserves to be reflected upon:

*"The premise of our analysis is that even if companies are not fully aligned with carbon neutrality, then at least investors should strive to be aligned by gradually reducing their carbon footprint through divestment of high-carbon emitters."*

*"Investors may want to do their part even if others do not, and if a sufficient mass of such investors align their portfolios to a net-zero target, then companies will be more incentivized to follow suit".*

These two simple sentences summarise the rationale for decarbonising portfolios and, thereby, the logic of the many parties pushing for the decarbonisation of financial portfolios. The underlying questions they pose are whether decarbonising financial portfolios is technically feasible, and whether divesting from high-carbon emitters will have an effect on those emitters and therefore contribute to climate change mitigation (in other words, whether the decarbonisation of financial portfolios will lead to the decarbonisation of the world).

Portfolio decarbonisation needs to be tested both technically and against reality.

From a technical standpoint, portfolio decarbonisation, when done on a large scale, raises two financial risk-related issues with far reaching consequences:

(i) It generates a high tracking error

With the world of investment management considering the tracking error as its main risk metric, common sense tells us that decarbonising large portfolios in a globally carbonised economy will create mechanically a high level of tracking error, which will be considered as financially unacceptable by investment managers, given the way the profession operates.

The reading of the two research papers already mentioned confirms this rather intuitive result, although explicitly for one and implicitly for the other. Le Guenedal et al., 2022 come to the conclusion that *"the decarbonisation path is more difficult and can involve a high degree of tracking error if we include scope 3 emissions"*, whilst, in contrast, Bolton et al., 2022 estimate that they can decarbonise a large scale (US \$ 1 trillion) portfolio without generating a significant tracking error. Without getting into debates beyond the scope of this report, we would argue that the two papers effectively lead to a similar conclusion given that the latter does not consider downstream scope 3 emissions (obviously very important in high emitting sectors such as energy and automobile); that it admits that the tracking error generated is highly dependent on the level of the remaining carbon budget at the time of construction of the portfolio (in a situation where the planet's carbon budget is today equivalent to 8 years' worth of emissions, constructing the portfolio in 4 years' time with an initial carbon budget 50% lower than today would generate a

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36 BOLTON et al; March 2022; page 1

tracking error of 10% by 2040); that it recognises that “*in the scenario where corporates do not lower their emissions, the aligned portfolio will have to dramatically reduce its carbon footprint, which generates a high tracking error*”; and finally that US \$ 1 trillion is still a relatively moderate number if we compare it, for instance, to the US \$ 130 trillion that GFANZ boasts to have mobilised to fund the world’s endeavours towards net-zero.

Most importantly, with projections of a 50% increase in the world’s GHG emissions by 2050<sup>37</sup> when they should by then have decreased by 95% to reach carbon neutrality, the tracking error of decarbonised portfolios will necessarily explode and quickly reach levels that will be considered unbearable by the asset management industry.

- (ii) It inflates artificially the price of low carbon intensive assets as too much money chases too few assets (so-called ‘green bubble’)

As we have seen, building a decarbonised investment portfolio comes down to investing as little as possible in high GHG emitting companies and replacing them with low GHG emitting companies.

The challenge that investment managers face here is to roll out the decarbonisation of portfolios at scale in a world where, given the highly GHG intensive global economy we live in, the pool of low GHG emitting companies will remain much more limited than the pool of high GHG emitting companies for many years.

This creates a quantitative limit to the size and the number of decarbonised portfolios that can be set up without creating a ‘green bubble’. With the mechanical necessity to replace high GHG emitting companies with lower GHG emitting companies, there is a high risk of too much money chasing too few assets resulting in an artificial bloating of green assets’ prices beyond any value justified by their economic fundamentals. In other words, there is a high risk of creating a green bubble and, as the history of financial crises has taught us, bubbles always end up bursting.

This reality exists regardless of whether net-zero targets are based on GHG intensity or absolute GHG emissions, although it will be even more acute if absolute emissions are considered.

## → **When climate-oriented asset allocation hits the wall of financial reality**

- (i) Climate conscious investors cannot build carbon neutral portfolios at scale

The two financial risks (tracking error and the formation of a green financial bubble) that we have identified as inherent to large scale carbon neutral portfolios lead to a simple if most unwelcome conclusion: that building very large carbon neutral portfolios is technically impossible, regardless of how desirable we may think they are.

In a highly carbon intensive economy, large investment portfolios that are built with low carbon emitting assets will see their performance diverge from mainstream benchmarks which are by nature carbon intensive as they mimic the general economy. This will remain the case for as long as the general economy has a high GHG content. Finance knows no such thing as miracles,

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<sup>37</sup> OECD and the PBL Netherlands Environmental Assessment Agency; *The Consequences of Inaction*; 2012 - Key facts and figures; Web Page.

and as long as investment risk is defined as diverging from the crowd, as inferred by the use of the tracking error as a risk metric, decarbonising a portfolio becomes impossible without taking unbearable risks. By defining risk as not being in line with the rest of the world, the investment management world has trapped itself and made conformism its ultimate measure of success. As too often forgotten, financial theories and the metrics attached to them do not merely describe financial reality, they shape it. Using the tracking error as a key risk metric makes the financial world impotent and unable to exert an influence on the real world: it has put on a straitjacket that prevents its asset allocation from influencing the real economic world.

Worse still, the rise of passive investing is taking the low tracking error to its extreme (by construction, passive investing has a zero tracking error) and transforms the investment activity into a purely mechanical exercise that consists of replicating the market. A passive investor has by definition no latitude to take any distance from its reference market benchmark. This, in a high GHG emitting economic world, means that a passively managed portfolio cannot avoid being invested in high GHG emitting companies. Even if the fund tracks a low-carbon benchmark, the use of intensity measures in portfolio assessment means it may still be investing in high GHG emitting companies (see box). With passive investment managing a growing share of the world's financial assets and on its way to overcoming active investment, the case for passive investment portfolios to be decarbonised at scale and to contribute to a decarbonisation of the world is non-existent as an asset allocation technique (but we will see in Section IV that it could exert a positive influence through engagement).

### **Paris-Aligned Benchmarks and Climate Transition Benchmarks**

Taking stock of the overwhelming use of benchmarks in the asset management world, whether in active or passive asset management, the EU adopted in November 2019 a Regulation for EU Climate Transition Benchmarks (CTB), EU Paris-aligned Benchmarks (PAB) and sustainability-related disclosures for benchmarks.<sup>38</sup>

Beyond their different levels of ambitions (PAB require an initial GHG emission reduction of 50% while CTB require an initial GHG emission reduction of 30%, both followed by a yearly reduction of at least 7%, among others), the use cases of Paris-aligned Benchmarks and of Climate Transition Benchmarks are the same: they aim to be a reference for passive investment strategies and a policy benchmark to help guide strategic asset allocation.

However, with the two families of benchmarks being based on an intensity logic<sup>39</sup> assessed at portfolio level, moreover with intensity defined as “*absolute GHG emissions divided by millions of euros in enterprise value including cash*”, these benchmarks will not contribute as such to making the world reach net-zero, regardless of their level of adoption by market and investment practitioners.

In summary, in today's portfolio management world, capital is allocated in such a manner as to follow the general economy, not to exert an influence on it. In the world of active investment, achieving

38 [Official Journal of the European Union](#) - Regulation (EU) 2019/2089 of the European Parliament and of the Council; November 2019; amending Regulation (EU) 2016/1011 as regards EU Climate Transition Benchmarks

39 For a discussion about intensity vs absolute emissions, see sections II.i and III.2.i

net-zero and limiting financial risk are contradictory objectives and will remain so as long as the general economy itself has not reached net-zero. In the world of passive investment, achieving net-zero is by construction impossible as the game consists of replicating a non-net-zero economic world.

Asset allocation no longer has the power to influence the world.

(ii) Bankers and insurers are unwilling to move away from financing carbon intensive activities.

Bankers may not have to worry about tracking errors but they have to follow another constraint that leads to the same consequence: bankers do not want to deviate from the position of financing the world as it is.

As mentioned earlier, the motivation of bankers is to increase the decarbonised part of their loan books, not to decrease their carbonised part nor the absolute level of financed emissions as long as those activities are considered profitable.<sup>40</sup> Two pieces of evidence support this view, from the refusal of top US banks to back shareholder proposals demanding stricter fossil fuel financing policies, despite being members of NZBA,<sup>41</sup> to Mark Carney saying it was “unrealistic”<sup>42</sup> to expect banks to eliminate the financing of carbon intensive industries.

The same can be said of insurance companies’ investment and underwriting activities. Witness the Letter of Commitment that members of NZIA must sign, which states “*How to achieve such an outcome through a 1.5°C net-zero transition pathway will be left to my company’s discretion*”.<sup>43</sup> Clearly, flexibility is also of the essence in the insurance industry with a view of not hindering business development, notwithstanding the fact that NZIA, for all its importance, represents ‘only’ 11% of the insurance premiums written globally. This effectively means that the decarbonisation of insurance underwriting portfolios will be slow if things remain the way they are today.

(iii) Non climate-conscious investors thrive on the tragedy of the horizons

A significant proportion of the world’s financial institutions is composed of (often proud) non-ESG, non-climate conscious investors who are happy to invest in assets generating high cash flows regardless of their carbon footprint. The behaviour of those cynical financiers who are too happy to pick up the good pieces falling from the ESG investing table is directly related to their conviction that they can still benefit in the short term from the cash flows generated by carbon intensive assets whilst being able to divest in time before things start to degenerate sometime in the future. This conviction takes its roots in a combination of the confidence they have in their perceived superior ability to anticipate market trends (behavioural overconfidence bias), and on the fact that the liquidity provided by markets gives them the possibility to exit. We are at the heart of the “tragedy of the horizons” described eloquently by Mark Carney in 2015.

In turn, this shows the limit of the decarbonisation of portfolios and, as the case may be, of its portfolio alignment sibling (see box). Contrary to Bolton et al., 2022, we do not believe that “if

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40 This phenomenon is taking place in an apparent contempt of the continued build-up of climate-related financial risks on banks’ balance sheets, which will become a threat to the continuity of banks’ transition financing when losses materialise.

41 Financial Times, 26 April 2022, [Investors at top US banks refuse to back climate proposals](#), by Aime Williams and Camilla Hodgson

42 Mark Carney’s declaration is coherent with the notorious push-back of GFANZ against the recommendation made by the IEA in its ‘Net Zero by 2050’ report to stop immediately to invest in new fossil fuel reserves.

43 United Nations Environment Programme - [Net Zero Insurance Alliance](#) - Statement of commitment by signatory companies; July 2021.

*a sufficient mass of such investors align their portfolios to a net-zero target, then companies will be more incentivized to follow suit*".<sup>44</sup> In our view, this description does not fit with the way the real world functions and we need to look for other means than asset allocation if we want financial institutions to contribute to moving the world towards GHG neutrality.

Interestingly, in its *Financial Sector Science-Based Targets Guidance*<sup>45</sup>, the SBTi affirms the same conviction when it says that "*the SBTi recognizes that there is a lack of clarity about which FI actions could lead to greenhouse gas emissions in the real economy*". The comment is a diplomatic way of expressing a strong doubt about the fact that portfolio decarbonisation can lead to a decarbonisation of the real world.

### **Can portfolio alignment make a difference?**

Portfolio alignment is the dynamic version of the more static portfolio decarbonisation. It is based on the principle of adjusting portfolios over time to ensure their alignment with the objectives of the COP 21 Paris Agreement.

Portfolio alignment being a dynamic financial asset allocation technique, it raises the question of whether it is an exercise in recognising the greening of financial portfolios as it takes place (e.g. when green mortgages replace traditional mortgages on a bank's loan book) or if it can contribute to aligning the real world with the Paris Agreement and related carbon trajectories – i.e. if it really incentivises transition in high emitting sectors and so decreases GHG emissions.

The portfolio alignment effort has attracted a vast number of scientific minds, competent organisations<sup>46</sup> and policy-makers<sup>47</sup> and developed a number of innovative concepts such as the notions of portfolio temperature alignment and temperature trajectories, in the majority of cases in reference with the Paris Agreement.

In our view, and recognising the high-level work done by the many specialists of the subject and the sophisticated techniques, portfolio alignment raises two issues that question its climate change mitigation effectivity:

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44 BOLTON et al; March 2022; page 1.

45 Science Based Targets Initiative (SBTi) - *Financial Sector Science-Based Targets Guidance*; February 2022; page 93.

46 A non-exhaustive list could consist, among others and in alphabetical order, of Arabesque, Carbon4 Finance, I Care, OECM (UNEP FI's One Earth Climate Model), PACTA, Portfolio Decarbonization Coalition, SBTi, S&P Trucost etc, not to mention the many universities throughout the world which have mobilised resources and put their best minds at work on the subject.

47 See for instance The Coalition of Finance Ministers - *Introduction to Commitments and Measurement Methods for Private Financial Sector Portfolio Alignment with the Paris Agreement*; Summary for Policymakers; May 2021.

1. Can asset allocation lead the world in a new direction, or does it follow the world? What does the Paris-alignment of financial portfolios change in the real world? Does it have an impact on actual GHG emissions? As already explained, we have the conviction that asset allocation follows the world and that it does not have the capability to influence the way of the world in the radically new direction of a zero GHG emitting economy. In our view, what is true for portfolio decarbonisation is also true for portfolio alignment.
2. As scientists, including the IPCC, tell us today that we will miss the objectives set by the Paris Agreement, what does an alignment with a missed Paris Agreement objective mean? What is the concrete sense of being aligned with an agreement that will not be translated into the real world? Will we end up with Paris-aligned investment portfolios and a non-Paris-aligned real world? Could this show that such an alignment has no influence on the world or that asset allocation is not the solution to reach GHG neutrality?

## IV. Climate-oriented stewardship as the main tool for financiers to help the transition to net-zero

The previous chapter argues that, for structural reasons, financiers are unlikely to drive real world decarbonisation through portfolio decarbonisation and portfolio alignment techniques. This chapter argues that financiers could have a higher real world impact through shareholder engagement and by imposing conditions on banking and insurance products. We introduce some regulatory ideas that could strengthen these two approaches.

### → Financiers need tools to make the transition to net-zero happen

Transitioning our highly GHG intensive economies towards GHG neutrality is the most important objective when it comes to mitigating climate change. This will require transforming radically the way we produce, sell and consume existing goods and services, in addition to promoting and financing new 'green' activities.

While this transition will require multiple policy interventions and forms of support, it will by nature, be realised by non-financial actors, and in particular by the non-financial companies that financial institutions bring capital to. This is where financiers can make a difference provided they are given the tools to do so. We need to think of the tools that financiers have or could have at their disposal to foster the transition of the economic world in the direction of decarbonisation.

We have shown in this report that portfolio decarbonisation (a form of asset allocation) can only have a limited effect on the decarbonisation of the world. However, financiers have another tool at their disposal, namely the power they have to exert influence on the companies they finance either through engagement or by linking the provision of capital to certain conditions. This is what stewardship is about, and it is something financiers have always done in relation to financial matters, either by engaging with companies through dialogue, in shareholders' General Assemblies or, as the case may be, as Board members, or by adding covenants to financing transactions in order to boost or protect their interests.

The time has come when climate-oriented stewardship must become the norm: engagement of shareholders, which has already started gaining momentum, must be enhanced and systematised by all equity investors, and new transition-linked financing mechanisms have to be developed, in particular by banking institutions and funds specialised in providing private debt or private equity. In order to achieve those objectives, the EU regulatory framework will need to be amended, which is coherent with Action 4 of the *Strategy for financing the transition to a sustainable economy*<sup>48</sup> announced by the European Commission on 6 July 2021.

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48 European Commission - *Strategy for financing the transition to a sustainable economy*; July 2021.



## → Making climate-oriented engagement by shareholders systematic

Climate-oriented engagement is mainly about equity investors (shareholders) pushing investee companies to transition towards carbon neutrality.

Asset allocation-wise, its operationalisation relies on the opposite logic to portfolio decarbonisation: shareholder status being a prerequisite to engagement, climate-oriented engagement supposes that financial institutions remain invested, at least to a degree. At their core, the modus operandi of investment portfolio decarbonisation through divestment and of engagement are thus not compatible, even if some investors use the threat of future divestment to add force to their engagement activities.

Engagement can take a number of different forms and depends on the framework provided by national corporate laws. It corresponds broadly to the right of shareholders to enter into a dialogue with the management of investee companies, to participate and vote in shareholders' ordinary and extraordinary general meetings, to propose, under conditions and with legal effects that vary from one jurisdiction to the other, resolutions to be voted in shareholders meetings, and to interact with the board of directors. Obviously, shareholders can also become Board members if and when they hold a sufficiently high fraction of the company's capital.

Engagement is more and more broadly seen today as an essential means by which investors can exert a positive influence on the sustainability of the business world. This is reflected in EU law with the Shareholder Rights Directive (SRD II)<sup>49</sup> placing a particular focus on "the encouragement of long-term shareholder engagement", but also in market practice with a broad recognition of its importance among climate change-conscious and ESG investors. This importance was clearly expressed by the SBTi in its *Foundations for science-based net-zero target setting in the financial sector* report<sup>50</sup> published in April 2022.

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*Extract (page 29) from SBTi's "Foundations for science-based net-zero target setting in the financial sector":*

*Guiding Principle 3: FIs should leverage their abilities to influence and engage other actors as well as focus their financing activities to help achieve economy-wide decarbonisation and a just transition, and not simply reduce portfolio exposure to GHG emissions.*

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However, if engagement is to be seen as the main tool at the disposal of the financial sector to decarbonise the world, action must be taken to avoid the risk of 'engagement-washing', in other words the risk of seeing investors claim they are engaging with issuers to push them towards carbon neutrality but effectively doing nothing and remaining invested in high GHG emitting companies in an undeclared 'business as usual' approach. Engagement must not be used as an excuse for financiers to do nothing of significance whilst pretending to be doing something: it cannot be a pretext for inaction nor a face-saving exercise.

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49 *Official Journal of the European Union* - Directive (2017/828) of the European Parliament and of the Council; amending Directive 2007/36/EC - encouragement of long-term shareholder engagement; May 2017.

50 Science Based Targets Initiative (SBTi) - *Foundations for Science-Based Net-Zero Target Setting in the Financial Sector*; April 2022.

Climate change-focused engagement is work in progress and it owes a lot to the work done by coalitions of investors such as Climate Action 100+,<sup>51</sup> Say on Climate,<sup>52</sup> As You Sow<sup>53</sup> or FIR.<sup>54</sup>

Climate Action 100+ covers 167 companies today and describes itself as seeking commitments from boards and senior management to:

- Implement a strong governance framework which clearly articulates the board's accountability and oversight of climate change risk;
- Take action to reduce greenhouse gas emissions across the value chain, consistent with the Paris Agreement's goal of limiting global average temperature increase to well below two degrees Celsius above pre-industrial levels, aiming for 1.5 degrees. Notably, this implies the need to move towards net-zero emissions by 2050 or sooner; and
- Provide enhanced corporate disclosure in line with the final recommendations of the Task Force on Climate-related Financial Disclosures (TCFD) and sector-specific Global Investor Coalition on Climate Change (GIC) Investor Expectations on Climate Change guidelines (when applicable), to enable investors to assess the robustness of companies' business plans against a range of climate scenarios, including well below two degrees and improve investment decision-making.

Say on Climate's purpose is to foster shareholder voting on climate transition action plans. It encourages companies to disclose their emissions, have a plan to manage them and hold an approval or disapproval vote where shareholders deem it appropriate.

As an association bringing together asset owners, asset managers, experts and civil society organisations, FIR has developed a strong presence in the field of climate-related engagement with Say on Climate demands addressed to SBF 120 CEOs<sup>55</sup> including both an increased level of transparency and the adoption of a climate strategy through the vote of a specific resolution in companies' annual general meetings.

For all the progress already made thanks, among others, to those initiatives, climate-oriented engagement results today in a low number of climate resolutions adopted in shareholder AGMs and limited impact on actual GHG emissions. Climate Action 100+ noted in a March 2022 report<sup>56</sup> that 69% of the world's highest emitters have made a net zero commitment but only 17% have a credible decarbonisation strategy. By the same token, BlackRock announced in April 2022 that it would not support more shareholder resolutions on climate change in 2022 because they have become too extreme or too restrictive.<sup>57</sup> At a time when carbon dioxide emissions are accelerating as never before,<sup>58</sup> this is a deeply worrying position to take for the largest asset manager on the planet (US \$ 10 trillion of assets under management) and a

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51 Climate Action 100+ - [List of Investor Signatories](#); Web page.

52 Say on Climate - [Shareholding voting on Climate Transition action plans](#); Web page.

53 [As You Sow - Organisation](#); Web page.

54 [Forum pour l'Investissement Responsable](#); Web page.

55 [Forum pour l'Investissement Responsable](#); [Say on climate - Statement](#); September 2021.

56 [Climate 100+ - Climate Action 100+ Net Zero Company Benchmark](#) shows an increase in company net zero commitments - Press release; March 2022.

57 Financial Times; [BlackRock warns it will vote against more climate resolutions this year](#) (Article); 10 May 2022; by Brooke Masters.

58 Financial Times; [Climate graphic of the week: Record carbon dioxide levels alarm scientists](#) (Article); 13 May 2022; by Leslie Hook and Chris Campbell.

clear indication of a low determination to exert influence to combat climate change by limiting GHG emissions.

Climate-oriented engagement must become more stringent and be associated with an obligation to obtain results if it wants to make a difference to real world GHG emissions and avoid the risk of ‘engagement-washing’.

A step in that direction was taken by the SBTi in its April 2022 report with its suggestions that *“FIs can discontinue financing companies that are unable or unwilling to transition, with clear public messaging such that the companies would find it increasingly difficult to access financing”*.<sup>59</sup> We share the view expressed implicitly by SBTi in this statement that if climate-oriented engagement is a tool without teeth it will not achieve anything.

With the objective of making climate-oriented engagement effective, of giving it teeth and of creating a momentum for companies’ transition and decarbonisation plans to become credible, we argue that the following three-point action plan should be implemented in relation to investors that claim to be ‘ESG’, ‘climate-oriented’ or ‘net-zero’ focussed (“ESG investors”):

1. Require ESG investors to explain and report publicly their plan of action to engage with investee companies and ensure they adopt credible transition plans (this would support the obligation proposed by Article 15 CSDDD to adopt transition plans,<sup>60</sup> especially if linked to the EU Taxonomy in order to make the plans credible and impactful, as suggested in Section II of this report);
2. Require ESG investors to vote against the management of investee companies in AGMs unless transition plans are both adopted and implemented, including for intermediate targets on intermediate dates (note, Art 15 CSDDD refers only to adoption);
3. Give a mandate to supervisors to check the reality of climate-oriented engagement and enforcement powers in relation to ESG investors;

From a legislation standpoint, this plan of action could be included in the upcoming review of SRD II (see point below). Such an inclusion would, among other things, have the merit of linking two pieces of EU law (CSDDD and SRD II) dealing with the two sides of the same sustainable finance coin, namely issuers and investors.

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59 Science Based Targets Initiative (SBTi) - Foundations for Science-Based Net-Zero Target Setting in the Financial Sector; April 2022; page 29.

60 *Official Journal of the European Council* - Commission Delegated (EU) 2021/2139 supplementing Regulation (EU) 2020/852 of the European Parliament and of the Council. June, 2021.

## → Developing transition-linked financing and insurance mechanisms

The practice of linking the provision of capital to financial and sometimes non-financial covenants has existed for a long time in different segments of the financial industry, for instance in the high-yield bonds market or in the field of private equity.

In order to bring substance to financial institutions' pledges to achieve net-zero targets, we propose that, going forward, the provision of capital or of insurance should be linked to climate-related covenants. As with existing financial or informational covenants, the scope of this approach could include debt, whether public or private, raised in capital markets, corporate loans extended by banking institutions, private equity as well as P&C insurance extended to business concerns.

Under this proposal, it would become mandatory for banks, insurance companies and funds that claim 'ESG', 'climate-oriented' or 'net-zero' status to include explicit covenants in their products and services that link to the transition plans of their customers.

Very much like companies' transition plans, the climate-related covenant mechanism could be based on the technical screening criteria established by the Delegated Act of the EU Taxonomy of sustainable activities for its climate change mitigation objective, and possibly on an Extended Environmental Taxonomy as proposed by the Platform on Sustainable Finance.<sup>61</sup> As already mentioned in the case of companies' transition plans, this would have the advantage of founding the mechanism on solid ground, of enabling financial supervisors to control the process and of enhancing the role of the EU Taxonomy for sustainable activities as a tool to foster the transition of the economy towards net-zero.

Transition-linked financing or insurance covenants would consist, for each activity financed or insured, of a transition pathway linking the present situation to a target situation with a precise date when the climate-related 'substantial contribution' criterion established by the EU Taxonomy for that particular activity should have been reached.

Concretely, a typical climate-related covenant would contain:

- A target date by which the company receiving the financing or benefiting from the insurance policy would commit to having reached the 'substantial contribution' threshold established by the Taxonomy technical screening criteria for its field of activity;
- Intermediate dates with intermediate targets towards reaching the final 'substantial contribution' threshold;
- Provisions enabling the financial institution providing capital (whether debt or private equity) or insurance to exert pressure on the financed or insured company in case it misses its intermediate or final targets. This could be done, in the same vein as the proposal made by SBTi regarding engagement, in one or several of the following ways:
  - ❖ Increase in the cost of the capital or insurance provided;
  - ❖ Early redemption of the capital or insurance provided;
  - ❖ Non-renewal / discontinuation of the capital or insurance provided;
  - ❖ Dismissal and replacement of top management.

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61 Platform on Sustainable Finance - *The Extended Environmental Taxonomy: Final Report on Taxonomy extension options supporting a sustainable transition*; March 2022.

Such a mechanism can be seen as taking the logic behind sustainability-linked bonds<sup>62</sup> one step further and making it systematic and coercive for financial institutions wishing to claim net-zero credentials. It would be a game-changer in the ability of financial institutions to exert a positive influence on the real economy to mitigate climate change and achieve its net-zero objective. If accessing capital and insurance coverage were conditional for companies on embarking on a transition pathway and achieving rigorously defined net-zero targets, then achieving those targets would become instantly a priority for them.

### → Amending EU legislation to enhance stewardship and engagement

In its *Strategy for financing the transition to a sustainable economy*,<sup>63</sup> the European Commission gave itself the objectives of “*accelerating the contribution of the financial sector to transition efforts*”, “*clarifying the fiduciary duties and stewardship rules of investors to reflect the financial sector’s contribution to Green Deal targets*” and “*enabling supervisors to address greenwashing*”. Amending EU legislation as suggested by the European Commission to clarify the fiduciary duties and stewardship rules of investors to reflect the financial sector’s contribution to Green Deal targets, to enhance stewardship and engagement would allow the inclusion in EU regulation of climate-related engagement and of transition-linked financing mechanisms as suggested in this report.

This inclusion would fit with the objective the European Commission has given to itself with the review of SRD II to “*explore how the SRD II may better reflect impact considerations and global best practices in stewardship guidelines*” and would entail broadening the scope of the ‘Shareholder Rights Directive’ to a ‘Capital Provider Rights Directive’ that would encompass both shareholders and creditors and thus allow not only for climate-related engagement but also for a transition-linked financing mechanism to be embedded into EU law.

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62 International Capital Market Association (ICMA) - *Sustainability-Linked Bond Principles Voluntary Process Guidelines*; June 2020.

63 European Commission - *Strategy for financing the transition to a sustainable economy*; July 2021.

Extract from the European Commission Strategy for financing the transition to a sustainable economy published on 6 July 2021:

**Action 4: The Commission will work to improve the contribution of the financial sector to sustainability goals.**

**4 (b): The Commission will clarify the fiduciary duties and stewardship rules of investors to reflect the financial sector's contribution to Green Deal targets.**

*Fiduciary duties*

- Ahead of the review of the IORP II Directive, the Commission will ask EIOPA to analyse the pension framework, notably to:
  - ❖ assess the potential need to broaden the concept of the “long-term best interests of members and beneficiaries” and introduce the notion of double materiality, taking into account members and beneficiaries’ sustainability preferences and broader societal and environmental goals; and
  - ❖ assess whether the prudent person rule should be clarified and/or explore possible avenues to require the integration of sustainability impacts in investment decision.
- In collaboration with the ESAs and building on the changes in fiduciary duty rules introduced by the package from April 2021, the Commission will consider merits of further changes to enable financial market participants and advisers to systematically consider positive and negative sustainability impacts of the products they advise on and of their investment decisions, including for UCITS, MIFID II, AIFMD and IDD entities. Such review would develop in continuity with the potential review of fiduciary duties through IORP II.

*Stewardship and engagement*

- The Shareholder Rights Directive (SRD II) provides a minimum baseline for stewardship activities, effective stewardship and long-term investment decision-making. Considering the review of the SRD II by 2023, the Commission will explore how the SRD II may better reflect impact considerations and global best practices in stewardship guidelines.
- The Commission will ask the ESAs and national regulator to develop further guidance to ensure acting in concert does not impede collaborative engagement by investors around common sustainability goals.<sup>64</sup>

→ **Promoting net-zero oriented investment products**

The landscape of climate change related financial products is blurred today by the profusion of difficult-to-fathom products, representing very different realities, having often a doubtful impact on climate change mitigation or adaptation, and being effectively unreadable even for specialists, let alone the general public.

<sup>64</sup> [European Securities and Markets Authority](#) - Public statement on 'Information on shareholder cooperation and acting in concert under the Takeover Bids Directive', ESMA/2014/677-REV - January 2019 (Updated).

This situation commands action in order to bring to the market a much-needed clarity and combat greenwashing.

The proposal is that, going forward, 'ESG', 'climate-oriented' or 'net-zero' status should be possible for financial institutions under the condition that they sell one or several of the three following streamlined and clearly defined climate change-related financial products:

- Taxonomy-aligned investment products: financial products bringing capital for the development of economic activities and technologies that contribute to mitigate climate change or adapt to it, as defined by the EU Taxonomy. This should include, obviously, enabling activities and activities in transition as defined by the EU Taxonomy. Taxonomy-aligned investment products should be Taxonomy-compliant. Given that only a (very) small fraction of economic activities are Taxonomy-compliant today, this means that Taxonomy-aligned investment products will cover only a small fraction of today's investment universe. This is not a problem given the other two climate change-related financial products we are proposing to develop in parallel that will cover the realm of the current GHG intensive economy and address the climate change mitigation issue from another angle. Taxonomy-aligned investment products would represent the opportunity side of the equation that the various net-zero alliances like to promote, and they would have a vocation to grow in size over the years as the general economy moves towards sustainability. More generally, the investment market would benefit enormously from having a clear and distinct category of Taxonomy-aligned investment products, to strengthen the current rules on sustainable investment products defined by Articles 8 and 9 of the Sustainability Financial Reporting Directive (SFDR) which do not require any alignment with the EU taxonomy, are extremely difficult to comprehend for the layperson and so risk misleading the general public.<sup>65</sup>
- Investment funds engaging with GHG emitting companies on their transition plans towards net-zero: those investment funds should adopt and put in practice the three-point action plan proposed in this report for climate change-oriented engagement, including the power given to financial supervisors to control the credibility and the effectiveness of the process (see supervision section below).
- Transition-linked financial products: financial products investing in (or representing) financial instruments (public bonds, private debt, bank loans and private equity) to which climate-related covenants are attached, as described in this report. This new category of climate-related financial products would require the intervention of supervisors to ensure that their reality corresponds to their narrative.

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<sup>65</sup> Finance Watch; March 2022; *Joint NGOs and consumer recommendations for minimum criteria for Art. 8 & 9 products under SFDR*.

## V. Role of supervisors in reaching net-zero targets

The previous chapter outlined proposals to help financiers drive decarbonisation in the real world, including through better shareholder engagement and the use of climate covenants. This chapter looks at the role of supervisors in making these proposals effective.

### → Information must be clear, accurate and not misleading

One of the principal and most important missions of financial supervisors, and in particular – if not exclusively – of financial markets supervisors, is to ensure that the information provided by issuers to investors and by financial institutions (whether banks, insurance companies or asset managers) to their customers is clear, accurate and not misleading. This mission is unanimously considered as indispensable to ensure the integrity of the financial marketplace and to allow investors and customers, both professional and retail, to make informed decisions.

With the prevalence of the sustainability debate and, in the case considered by this report, of the climate change debate and of net-zero targets in the financial world, the need for financial supervisors to step in to ensure that net-zero and climate change-related information is clear, accurate and not misleading is now urgent.

Two reasons support this position:

- The universal emergence of sustainable finance is attracting a growing level of interest from retail investors and, as a consequence, from institutional investors and financial institutions, in the climate impact of investments and of financing activities. However, the current confusion around net-zero pledges and their actual meaning is becoming more and more problematic. Net-zero pledges are a fertile ground for unclear and misleading information. This must be controlled if the financial system wants to preserve its integrity and avoid misleading investors and other stakeholders, including climate-conscious citizens and consumers.
- Climate change-related information has broad financial consequences for market participants and if the information provided is not clear and accurate or is misleading, market participants cannot properly assess the climate change-related financial risks they incur. For instance, a financial institution's claim to be net-zero may sound reassuring risk-wise, but without information on whether it considers GHG absolute emissions or intensity, or on how it accounts for scope 3 emissions and carbon offsets, the claim cannot be used to make informed risk management decisions (however neat the carbon accounting, planting trees will not hedge stranded asset risk). Net-zero or GHG neutrality claims must not enable risks to be concealed and any 'risk-washing' must be controlled if the financial system does not want to run blindly into a climate change-induced financial crisis. This is made all the more important by the fact that supervisors also have a mandate to review and assess financial institutions' business models, strategies and risk management practices with a view of assessing their ability to withstand financial shocks. This makes for the absolute necessity for climate change-related information and net-zero claims to be reviewed and assessed by supervisors.



## → Amending EU legislation to empower supervisors

In its *Strategy for financing the transition to a sustainable economy*<sup>66</sup> released on 6 July 2021, the European Commission gave itself the task of “enabling supervisors to address greenwashing”. This endeavour can only be encouraged, given the urgency of the question. Without prejudging the conclusions of the work that will be done by the European Supervisory Authorities (ESAs) on the subject, it should be a priority to amend EU legislation to empower supervisors to address effectively net-zero greenwashing.

*Extract from the European Commission Strategy for financing the transition to a sustainable economy published on 6 July 2021:*

**Action 5: The Commission will work to monitor an orderly transition and ensure the integrity of the EU financial system.**

**5 (a): The Commission will enable supervisors to address greenwashing.**

- In cooperation with the ESAs, the Commission will assess whether supervisory powers, capabilities and obligations of Competent Authorities as well as the enforcement measures taken by competent authorities are fit for purpose to effectively fight greenwashing. This includes the monitoring of greenwashing risks by the ESAs and competent authorities.
- As part of this assessment, the ESAs will be asked to assess and report to the Commission whether the current supervisory and enforcement toolkit available to competent authorities for monitoring, investigating and sanctioning greenwashing is sufficiently efficient, consistent and deterrent across the EU and whether it is fit for purpose in identifying possible greenwashing risks throughout the product lifecycle.
- Subsequently, the Commission will consider whether further steps are necessary to enable supervisors to ensure a sufficient and consistent level of supervision and enforcement across the EU. The Commission will consider the need for a stronger co-ordination and convergence role by the ESAs or other amendments to EU legislation.

Implementation of plans, materiality of claims and accuracy of information being of the essence, net-zero supervisory action must be developed and made systematic for non-financial corporate issuers, for financial institutions and for carbon offsets and avoided emissions certifiers:

## → Supervising non-financial companies' GHG neutrality claims

The essential piece of the ‘net-zero chain’ is the effectiveness of non-financial companies’ GHG neutrality policies. It is therefore essential that supervisory action be taken to control non-financial companies’ GHG neutrality claims and publicly announced net-zero targets against the reality of the policies implemented and of their results.

Two blocks of action must and can be taken to address the materiality of net-zero objectives, to ensure issuing companies’ GHG neutrality claims are founded and therefore to avoid net-zero greenwashing:

<sup>66</sup> European Commission - *Strategy for financing the transition to a sustainable economy*; July 2021.

(i) Control the substance of companies' net-zero reporting

Financial supervisors should control the quality of the GHG reporting of companies claiming to be GHG neutral or pursuing net-zero targets.

As proposed in this report,<sup>67</sup> financial supervisors should control the fact that companies reporting net-zero targets or claiming to be carbon neutral follow the five following rules:

1. Consider absolute GHG emissions, not GHG intensity;
2. Account for all scope 1, 2 and 3 emissions;
3. Take into account only existing, as opposed to hypothetical, carbon dioxide removal (CDR) combined with existing permanent sequestration techniques effectively counter-balancing today, at the scale required and reported, their own GHG emissions;
4. Do not consider offsetting in GHG neutrality assessments;
5. Do not consider avoided emissions in GHG neutrality assessments.

All issuers claiming GHG neutrality or net-zero pledges should be able to demonstrate to market supervisors that their claims follow those five rules, and supervisors should be in a position to control the materiality of the claims and be empowered to impose sanctions in case of false or rigged reporting.

(ii) Make companies' GHG transition pathways more enforceable

Along with companies covered by the Corporate Sustainability Reporting Directive (CSRD) disclosing their transition pathway to reach GHG neutrality by 2050, including intermediate steps set every five years from 2030 onwards (2030, 2035, 2040 and 2045),<sup>68</sup> supervisors should be empowered to control the effectiveness of the transition pathways of reporting companies and be able to impose sanctions in case of non-compliance. In order to be effective, the power given to supervisors should, as described in Section II of this report, cover both the adoption and the implementation of companies' transition plans.

## → **Supervising financial institutions' net-zero claims**

The new supervisory context would be one where financial institutions' net-zero claims would have to be substantiated by demonstrating that they develop one or several of the three categories of net-zero-oriented financial products proposed in this report (Taxonomy-aligned investment products, investment funds engaging with GHG emitting companies and transition-linked financial products).<sup>69</sup>

- The supervision of Taxonomy-aligned investment products would entail controlling that those products are fully Taxonomy-aligned.
- The supervision of investment funds engaging with GHG emitting companies would entail:
  1. Ensuring that investors claiming 'ESG', 'climate-oriented' or 'net-zero' status explain and make public their plan of action to engage with investee companies in order to push them to transition towards carbon neutrality;

67 See "DOs" and "DON'Ts" for net-zero pledges of non-financial companies to be considered as material from a climate perspective, Section II. iv.

68 Eurosif; *Principles for Responsible Investment; Ensuring a future-proof sustainability reporting framework that supports meaningful transition effort - Letter*; April 2022.

69 See section IV.

2. Controlling whether investors claiming 'ESG', 'climate-oriented' or 'net-zero' status vote climate resolutions in AGMs and, as the case may be, engage with investee companies throughout the year on the subject of GHG neutrality and transition plans;
  3. Controlling that investors claiming 'ESG', 'climate-oriented' or 'net-zero' status follow the implementation of investee companies' announced net-zero action plan and take action in case of non-implementation, for instance by voting against the management of investee companies in general assembly meetings or by discontinuing investment;
- The supervision of transition-linked financial products would entail:
    1. Controlling for each activity financed, the existence of a transition pathway of the financed company linking the present situation to a target situation;
    2. Controlling the existence and the realism of the target date by which the company receiving the financing commits to having reached the 'substantial contribution' threshold established by the EU Taxonomy Technical Screen Criteria Delegated Act<sup>70</sup> for its field of activity;
    3. Controlling the existence of intermediate dates with intermediate targets towards reaching the ultimate 'substantial contribution' threshold;
    4. Controlling the existence of covenants enabling the financial institution to exert pressure on the financed company (through increasing the cost of capital provided, discontinuation of financing, replacement of top management...) in case it misses its intermediate or final targets.

Financial institutions and financial products that cannot demonstrate genuine climate change-oriented action as defined in the three-pronged approach above should be prohibited by supervisors from promoting themselves or the funds they sell with any reference to climate change mitigation, GHG neutrality, carbon neutrality or net-zero targets.

## → Supervising carbon offsets certifiers

Even if, as explained in this report, carbon offsets and avoided emissions should not be included in companies' GHG neutrality assessments given their in-built fragility, the mere fact that the market for carbon credits linked to carbon offsets and avoided emissions is expected to grow from a current \$ 800 million to \$ 50 billion commands supervisory action by specialised public authorities.

A number of aspects must be supervised to ensure that this market corresponds to a tangible reality. For instance, and non-exhaustively, supervision could consider the selection and the guarantee of the quality of the offset programs, the type of projects used (natural or technological, sequestrations or avoidance), the duration of storage in the event of sequestration credits, the methods used to calculate the avoided emissions, and the uniqueness of the carbon credits generated to ensure that the same credits are not sold several times.<sup>71</sup>

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70 *Official Journal of the European Council* - Commission Delegated (EU) 2021/2139 supplementing Regulation (EU) 2020/852 of the European Parliament and of the Council. June, 2021.

71 A rigorous assessment of those principles can be found in the *Oxford Principles for Net Zero Aligned Carbon Offsetting*; September 2020.

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A number of certification providers have started to operate in that field with, unsurprisingly, various degrees of quality. The only way to keep the situation under control and avoid confusion in this burgeoning market is for regulators to step in.

## Conclusion

Net-zero is caught in a tension. Some, whether on the cynics' or on the critics' side, see it as the new buzz word for business as usual, while a growing community sees it as the quintessential tool to mitigate climate change by decarbonising the real economy. Which is it to be?

International standard setters and policymakers, as well as financial sector business alliances such as GFANZ, are working on definitions of net-zero that should help to answer that question. When their work is done, what remains in the 'net' of net-zero will be crucial for determining if the concept will help to decarbonise the economy or risk being discredited as greenwashing tool.

The recommendations in this report reflect the view that the more truthful the definition of net-zero, the better our chances of avoiding climate catastrophe. With only a few years remaining to stabilise atmospheric CO<sub>2</sub> at safe levels, now is not the time to risk fooling ourselves with definitions that rely on intensity measures, carbon offsets, or unrealistic hopes of future carbon capture, however attractive these are to report a seemingly positive message in the short-term.

As this report went to press, GFANZ was launching a consultation on its recommendations and guidance to "Financial Institution Net-Zero Transition Plans".<sup>72</sup>

Some aspects of the GFANZ consultation leave room for scepticism, including the call to build net-zero plans on financial materiality-oriented TCFD principles, the flexibility on scope 3 emissions reporting, the somewhat ambiguous and potentially offsets-complacent definition of net-zero, and the explicit allowance of natural gas as a 'transition asset'.

On the other hand, GFANZ's intention to work with policymakers and security regulators "with insight into the actions being taken by financial institutions and companies to deliver on their stated commitments" can only be supported as can the engagement strategy that it is promoting, provided it can be given more teeth, as we propose in this report. The current EU legislative agenda gives the opportunity to develop a system of enhanced stewardship through which the financial sector can drive decarbonisation of the real economy. Beyond the borders of the EU, similar legislation should also be adopted.

In the background, prudential policymakers continue their work on making financial institutions more resilient to the risks of climate change.<sup>73</sup> These two debates – on net-zero and on climate prudential risks for financial institutions – are linked by the idea of double materiality, which should be a prominent feature in both policy responses. However, the specific policies in each area are different and cannot substitute for each other: prudential policy aims to protect the stability of the financial system and net-zero policy aims to decarbonise the real economy.

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72 GFANZ; [Financial Institution Net-Zero Transition Plans](#)

73 Finance Watch has led calls for regulators to recognise fossil fuel assets as a higher risk category of assets in banking and insurance prudential regulation as part of this ongoing discussion. See Finance Watch's reports [Breaking the Climate Finance Doom Loop](#), June 2020, [Insuring the uninsurable](#), July 2021, [A silver bullet against Green Swans](#), November 2021, and Finance Watch's evidence given in March 2022 to the European Parliament Hearings on the [Finalisation of Basel III and the Review of Solvency II](#).

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This report introduces several ways for policymakers to drive progress to net-zero in the real world and direct the stewardship powers of the financial sector to the same end. The route that policymakers take will determine whether the world moves effectively towards carbon neutrality, or not. The net-zero concept can be a powerful tool for the journey to carbon neutrality, but only if we define it well and use it to conduct policies and practices that will make a difference.

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## About Finance Watch

Finance Watch is an independently funded public interest association dedicated to making finance work for the good of society. Its mission is to strengthen the voice of society in the reform of financial regulation by conducting advocacy and presenting public interest arguments to lawmakers and the public. Finance Watch's members include consumer groups, housing associations, trade unions, NGOs, financial experts, academics and other civil society groups that collectively represent a large number of European citizens. Finance Watch's founding principles state that finance is essential for society in bringing capital to productive use in a transparent and sustainable manner, but that the legitimate pursuit of private interests by the financial industry should not be conducted to the detriment of society. For further information, see [www.finance-watch.org](http://www.finance-watch.org)

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