BRIEFING

EU Legislation in Progress

Sustainable finance and benchmarks

Low-carbon benchmarks and positive-carbon-impact benchmarks

OVERVIEW

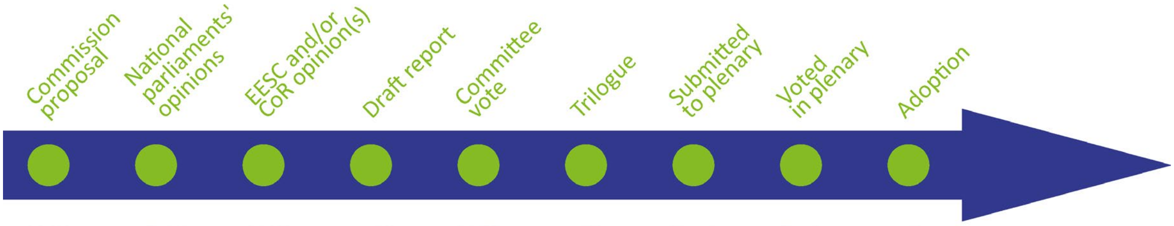
In May 2018, the European Commission presented a package of measures on the financing of sustainable growth. The package includes three proposals aimed at establishing an EU taxonomy on sustainable economic activities, improving disclosure requirements and creating a new category of financial benchmarks to help investors measure the carbon footprint of their investments.

Financial benchmarks have an important impact on investment flows. Many investors rely on them for creating investment products, measuring their performance and devising asset allocation strategies. The Commission proposes to create a new category of benchmarks comprising low-carbon and positive-carbon-impact benchmarks, by amending the Benchmark Regulation. As the regulation is directly applicable, amending it would restrict the possibility of divergent measures being taken by the competent authorities at national level.

Parliament voted in plenary on 26 March 2019 to approve the compromise text agreed in trilogue negotiations. Following approval of a corrigendum by Parliament in October, the Council adopted the text on 8 November 2019. The final act was signed on 27 November 2019, published in the Official Journal on 9 December and entered into force the following day.

Proposal for a Regulation of the European Parliament and of the Council amending Regulation (EU) 2016/1011 on low carbon benchmarks and positive carbon impact benchmarks

Committee responsible:	Economic and Monetary Affairs (ECON)	COM(2018) 355 24.5.2018
Rapporteur:	Neena Gill (S&D, United Kingdom)	
Shadow rapporteurs:	Anne Sander (EPP, France) Kay Swinburne (ECR, United Kingdom) Lieve Wierinck (ALDE, Belgium) Matt Carthy (GUE/NGL, Ireland) Molly Scott Cato (Greens/EFA, UK Barbara Kappel (ENF, Austria)	2018/0180(COD) Ordinary legislative procedure (COD) (Parliament and Council on equal footing – formerly 'co-decision')
Procedure completed.	Regulation 2019/2089 [OJ L 317, 9.12.2019, pp. 17–27]().	



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PE 640.135 – January 2020

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Introduction

The European Union (EU) is committed to the objective of establishing a more sustainable economy through the adoption of the Paris Agreement on Climate Change and the UN 2030 Agenda for Sustainable Development. To achieve the targets agreed in Paris, including a 40 % cut in greenhouse gas emissions, around €180 billion of additional investment flows a year are needed.

Financial benchmarks[1] have a significant impact on investment flows. Many investors rely on them for creating investment products, measuring their performance and devising asset allocation strategies. However, the Commission has noted that there is a lack of appropriate and objective low-carbon indices that could be used as a reference.

In addition, there is currently a high risk of 'greenwashing', due to different levels of disclosure of benchmark methodologies. Greater transparency and guidance would allow investors to use and select benchmarks in a manner that is consistent with long-term investment strategies, and to drive allocation of capital towards more sustainable investments.

To address the above situation, the Commission submitted a proposal (COM(2018) 355) to create a new category of benchmarks by amending Regulation (EU) 2016/1011 (the Benchmark Regulation). The new category would comprise two types of benchmarks: **low-carbon benchmarks** and **positive-carbon impact benchmarks**.

Low-carbon benchmarks would be based on 'decarbonising' standard benchmarks (e.g. an equity index similar to the Standard and Poor's 500), and would be used for risk diversification. The underlying stocks would be selected on account of their reduced carbon emissions when compared to stocks constituting a standard benchmark.

On the other hand, **positive-carbon impact benchmarks** would be a more ambitious type of benchmark aligned with the Paris Agreement objective of limiting global warming to well below 2°C. The underlying stocks would be selected on account of their carbon emission savings exceeding the stocks' residual carbon footprint.

Furthermore, the Commission proposal introduces a requirement for benchmark administrators responsible for producing environmental, social and governance (ESG) benchmarks to disclose how they take account of ESG considerations.

Context

Over the years, **asset managers have designed hundreds of climate-related stock indices and funds**. The approaches and methodology adopted have evolved and have become more sophisticated.[2] Nevertheless, measuring the carbon footprint of an investment portfolio is still a complex task.

Even if the quantity and quality of data disclosed by issuers has improved, there is a **data reliability bias**, since there is no third-party verification. In addition, the lack of harmonisation of methodologies and the broad range of choices of methods and techniques to measure the carbon footprint results in costs for benchmark providers and confusion for investors.

For instance, with regard to the Greenhouse Gas Protocol Corporate Standard,[3] the vast majority of companies do not disclose scope 3 emissions (indirect carbon emissions caused by users or suppliers of a company), which could have a higher impact in terms of greenhouse gas (GHG) emissions than scope 1 emissions (emissions from sources that are owned or controlled by the organisation) and scope 2 emissions (emissions from the consumption of purchased electricity, steam or other sources of energy generated upstream from the organisation).

Therefore, the majority of index providers disregard scope 3 emissions for a number of reasons: on the assumption that companies have no control over these emissions ; because these emissions are more difficult to measure; and because they rely on corporate reporting, which in the best case only covers scopes 1 and 2.

Almost all low-carbon index providers that consider only scope 1 and 2 emissions tend to exclude utilities, materials production and energy companies as the top carbon-emitting sectors from their index, essentially including only services industries (e.g. financial, telecommunications and information technology). This is because services tend to score best in terms of scope 1 and 2 emissions. Low-carbon index providers tend to overweight financials and service industries while underweighting the utilities, materials and energy sectors. However, this 'disinvestment' approach is neither a comprehensive nor an appropriate response to aligning financial investments with climate concerns.

For these reasons, the majority of stakeholders interviewed by the Commission on the usefulness of a harmonised methodology for a low-carbon index observed that there is merit in developing such a methodology at the EU level, but stressed the importance of reliable data on indirect carbon emissions caused by users or suppliers of a company (scope 3 emissions).

Existing situation

At the global level, the harmonisation of rules governing the production and use of financial benchmarks has been recognised by the G20 and the Financial Stability Board (FSB); consequently, the latter has entrusted the International Organization of Securities Commissions (IOSCO) with producing a global set of principles applying to financial benchmarks. In European Union law, the IOSCO principles have been introduced through the Benchmark Regulation.

However the absence of EU harmonised rules for low-carbon benchmarks has created divergent standards for these benchmarks, potentially leading to investor confusion and a suboptimal choice of indices to measure the performance of low-carbon funds and products. Furthermore, **existing benchmarks lack transparency with regard to their methodologies**, and fund managers pursuing a low-carbon or Paris-aligned investment strategy lack a reliable index to benchmark their performance.

While some benchmarks are only used nationally, others featuring in financial contracts and products are often used in a cross-border manner. Action at the national level in relation to an index may help ensure that such an index is appropriately tailored to meet specific national considerations. However, it risks missing the cross-border dimension and may ultimately lead to a patchwork of divergent rules, creating an uneven playing field within the single market and resulting in an inconsistent approach across the EU.

Respondents to a Commission questionnaire on the usefulness of harmonised standards for the methodology for low-carbon indices declared that they do not currently use a low-carbon index, because they believe that: i) current methodologies do not reflect all sources of CO_2 emissions; ii) their clients (investors) have no confidence in the methodologies employed by available low-carbon indices; and iii) none of the existing low-carbon indices reflect their investments' approach and style.

Comparative elements

In France, Article 173 of the Law on energy transition and green growth introduced an innovative reporting approach that essentially requires investors to disclose (on a 'comply or explain' basis) how their portfolio selection meets a 2°C trajectory. These methodologies are based on a scenario analysis.

The 2° Investing Initiative, in partnership with eight institutions, is developing a free open-source methodology/framework that would allow assessment of the alignment of an investment portfolio with the 2°C climate goal[4] and with various decarbonisation scenarios.

Parliament's starting position

On 29 May 2018, the European Parliament adopted a resolution on sustainable finance. Members of the European Parliament largely supported the Commission's initiative, agreeing on the essential role of the financial sector as regards sustainability and on the need for policies aimed at correcting market failures.

Members recommended that passive funds led by index-based investment should be encouraged to disclose their stewardship activities and the extent to which the use of passive indexing and benchmarking allows for the proper identification of ESG risks in investee companies. In the Members' opinion, index providers should be asked to provide details of the exposure of widely used and referenced benchmarks to climate and sustainability parameters.

The resolution highlighted that none of the widely used financial benchmarks consider ESG factors in their methodology; it further called for the development of one or more European sustainability benchmarks, using the European sustainability taxonomy (COM(2018) 353), to measure the performance of European issuers on the basis of ESG risks and factors.

Preparation of the proposal

In December 2016, the Commission established a high-level expert group (HLEG) to develop a comprehensive EU strategy on sustainable finance. In its final report, the expert group dedicated a specific cross-cutting chapter to benchmarks and recommended updating benchmark guidance and regulations to ensure that they take sustainability issues into account.

The Commission also interviewed a diverse group of stakeholders, including respondents specialising in asset management, benchmarks administration, market infrastructure, banking and advocacy, as well as think-tanks. Stakeholders were consulted on i) the need for harmonising the standards for methodologies at the European level; ii) barriers to the use of low-carbon indices; and iii) key elements that should be included in a methodology for low-carbon benchmarks.

Ahead of making the proposal, the Commission carried out an impact assessment (IA), in which it analysed different policy alternatives:

- **option 1**: no EU action;
- **option 2**: improving the transparency of the methodology and establishing minimum standards for 'decarbonised' or 'low-carbon' indices;
- **option 3**: harmonised EU rules for 'pure-play' low-carbon or 'positive carbon impact' indices that align with the 2°C objective;
- **option 4, sub-option a)**: minimum standards for harmonising the methodology to be applied to low-carbon indices and 'positive-carbon-impact' indices;
- **option 4, sub-option b)**: harmonised EU rules for different types of low-carbon indices.

Sub-option 4a emerged as the preferred one. The initial appraisal of the IA carried out by EPRS recognised that the IA's preferred option was selected after considering both non-legislative and regulatory approaches. The IA does not include an analysis of competitiveness nor an analysis of impacts, if any, on SMEs. Nonetheless, the Commission has consulted a broad range of stakeholders extensively, whose views have been satisfactorily reported in the IA or in the separate document containing the results of the second open public consultation.

The changes the proposal would bring

The proposal would introduce two main changes: new categories of benchmarks to assess investment portfolios against climate targets; and new transparency obligations for benchmark providers to disclose how their methodology takes into account ESG factors.

With regard to new categories of benchmarks, the proposal would introduce low-carbon benchmarks and positive-carbon-impact benchmarks into the Benchmark Regulation. The Commission would be empowered to adopt delegated acts to further specify the key elements of low-carbon and positive-carbon-impact benchmarks. These acts would feature criteria for the choice of the underlying assets, including, where applicable, the exclusion criteria for assets; the criteria and method for weighting the underlying assets in the benchmark; and the method for calculating carbon emissions and carbon savings associated with the underlying assets.

With regard to new transparency obligations, administrators of benchmarks or families of benchmarks that pursue or take into account ESG objectives would have to provide an explanation of how the ESG factors are represented by the methodology used to structure the benchmark. The Commission would be empowered to adopt delegated acts to further specify the minimum content of such disclosures.

Advisory committees

On October 2018, the European Economic and Social Committee (EESC) adopted an opinion addressing both the proposal on Sustainable Finance and Taxonomy COM(2018) 353 and the proposal on Sustainable Finance and Benchmarks COM(2018) 355. The Committee welcomed the development of new low-carbon and positive-carbon-impact benchmarks, as they would make more and better climate-related information available and would ensure its comparability. It further pointed out that information and communication with all stakeholders, operational businesses and the general public should be developed through a plan that would include financial education and training, among other things.

National parliaments

The subsidiarity deadline for national parliaments to submit comments on the proposals was 24 September 2018. No reasoned opinions were submitted.

Stakeholders' views[5]

The European Fund and Asset Management Association (EFAMA) welcomed the Commission's goal of developing a harmonised approach to ensure robust methodologies for low-carbon and positive-carbon-impact benchmarks, while also providing a number of recommendations with regard to this approach. These include creating the right incentives without seeking to dictate how capital is directed; clarifying that asset managers can continue to use non-sustainability benchmarks; drawing up the benchmark statement provided for by the Benchmark Regulation as a user-friendly document; and including an implementation timeline in the proposal.

The Finance Watch NGO recommended that the proposed low-carbon and positive-carbon-impact benchmarks be classified under the sustainability taxonomy, remarking that the proposal makes it clear that benchmark administrators would not be required to use the EU taxonomy when selecting the underlying assets. In the NGO's opinion, this seems to be in conflict with the overarching objective of providing clarity regarding what investments can be considered sustainable.

Better Finance, in its feedback on the Commission's proposal, insisted on making it clear that the proposed regulation would be used by professional investment intermediaries, but not by individual end-investors in general. It further pointed out that, before adding environment-specific indices, the EU should first strengthen the rules on standard indices (as well as the enforcement of these rules), so as to ensure that they are properly understood and used by financial intermediaries.

It expressed disagreement with the Commission's choice to unbundle the benchmark methodology from the EU taxonomy. Last but not least, it demanded the inclusion of a prominent warning to end-investors to the effect that carbon benchmarks cover only a very specific part of environmental issues and not the entire climate change spectrum or any social or governance issues.

Legislative process

The legislative proposal (COM(2018) 355) was presented by the Commission on 24 May 2018. In the European Parliament, the dossier was assigned to the ECON committee. The ENVI committee and the ITRE committee were invited to give opinions. ENVI provided its opinion on 22 November 2018, while ITRE decided not to give an opinion. The ECON rapporteur, Neena Gill (S&D, United Kingdom), published her draft report on 27 September 2018. On 13 December, ECON adopted its report and voted to open interinstitutional negotiations. Council agreed its position on 19 December 2018. After trilogue negotiations, on 25 February 2019, the Romanian EU Council Presidency and the European Parliament reached a preliminary agreement. Parliament voted to approve the interinstitutional agreement on 26 March 2019 in plenary session. Because of the tight timeline for finalisation, linguistic corrections to the voted text could not be completed before the end of the parliamentary term. After Parliament's approval of a corrigendum in October, the Council adopted the text on 8 November 2019. The President of the European Parliament and the President of the Council signed the text on 27 November. The Regulation was published in the Official Journal on 9 December, and entered into force the following day.

Interinstitutional agreement

The compromise text includes a number of changes to the Commission's initial proposal.

In Article 1, the concept of 'EU Climate Transition Benchmark' replaces the 'low-carbon benchmark'. In the original proposal, the underlying assets of a benchmark should have been selected so that the resulting benchmark portfolio would have had less carbon emissions when compared to the assets that comprise a standard capital-weighted benchmark. Under the new concept, the underlying assets of a benchmark are selected, weighted or excluded in such a manner that the resulting benchmark portfolio is on a decarbonisation trajectory.[6]

Also in Article 1, the concept of 'EU Paris-aligned Benchmark' replaces the 'positive carbon impact benchmark'. In the original proposal, the underlying assets of a benchmark should have been selected on the basis that their carbon emissions savings exceed the assets' carbon footprint. Under the new concept, the underlying assets of a benchmark are selected in such a manner that the resulting benchmark portfolio's carbon emissions are aligned with the long-term global warming target of the Paris Climate Agreement.

By 31 December 2021, all benchmarks or families of benchmarks should, in their benchmark statement, include an explanation of how their methodology aligns with the target of carbon emission reductions or attains the long-term global warming target of the Paris Climate Agreement.

Furthermore, by 31 December 2022, the Commission must present a report to the European Parliament and the Council on the impact of the regulation, taking into account the evolving nature of sustainability indicators and the methods used to measure them.

Article 2 states that a benchmark administrator providing an EU Climate Transition or an EU Paris-aligned Benchmark must comply with the requirements set out in the regulation by 30 April 2020. Such a deadline was not included in the original proposal.

EP SUPPORTING ANALYSIS

S. Vettorazzi, An EU framework to facilitate investments in environmentally sustainable economic activities, initial appraisal of the Commission IA accompanying the legislative package, EPRS, European Parliament, April 2019.

OTHER SOURCES

Low carbon benchmarks and positive carbon impact benchmarks, European Parliament, Legislative Observatory (OEIL).

Resolution of 29 May 2018 on sustainable finance (2018/2007(INI)), European Parliament, 2018.

Proposal for a Regulation of the European Parliament and of the Council amending Regulation (EU) 2016/1011 on low carbon benchmarks and positive carbon impact benchmarks, COM(2018) 355, European Commission, 24 May 2018.

Impact Assessment, COM(2018) 264, European Commission, 24 May 2018.

Action Plan: Financing Sustainable Growth, COM(2018)97, European Commission, 8 March 2018.

Final report, High Level Expert Group on Sustainable Finance, 31 January 2018.

Financing Sustainability: Triggering Investments for a Clean Economy, European Political Strategy Centre, 8 June 2017.

Principles for financial benchmarks. Final report, International Organization of Securities Commissions (IOSCO), July 2013.

Statement on matters to consider in the use of financial benchmarks, IOSCO, 5 January 2018.

MSCI global low carbon target indexes methodology, MSCI, May 2018.

Beyond divestment: using low carbon indexes, MSCI, May 2018.

ENDNOTES

1. Financial benchmarks are indexes that synthetically represent a set of underlying data and related changes.
2. Reference to the Impact Assessment accompanying proposal SWD(2018) 264 final, p. 185 – Basics of existing 'low-carbon' methodologies and index construction.
3. The GHG Protocol Corporate Standard classifies a company's GHG emissions into three 'scopes'. Scope 1 emissions are direct emissions from owned or controlled sources. Scope 2 emissions are indirect emissions from the generation of purchased energy. Scope 3 emissions are all indirect emissions (not included in scope 2) that occur in the value chain of the reporting company; these include both upstream and downstream emissions.
4. The project Developing Sustainable Energy Investment (SEI) metrics, benchmarks and assessment tools for the financial sectors, financed by the European Commission.
5. This section aims to provide a flavour of the debate and is not intended to be an exhaustive account of all different views on the proposal. Additional information can be found in related publications listed under 'EP supporting analysis'.
6. 'Decarbonisation trajectory' means a measurable, science-based and time-bound trajectory to reduce scope 1, 2 and 3 carbon emissions towards alignment with the long-term global warming target of the Paris Climate Agreement.

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Second edition. The 'EU Legislation in Progress' briefings are updated at key stages throughout the legislative procedure.