Portfolio Alignment for Financial Institutions

SBTi response to the TCFD proposed guidance on Metrics, Targets, and Transition Plans

1. Overview

The Science Based Targets initiative (SBTi) accelerates decarbonization in the real economy by driving the adoption and implementation of corporate greenhouse gas emission reduction targets in line with what the latest climate science says is necessary to meet the goals of the Paris Agreement. The SBTi is a collaboration between CDP, the United Nations Global Compact (UN Global Compact), World Resources Institute (WRI) and the World Wide Fund for Nature (WWF) and is one of the We Mean Business Coalition commitments.

The SBTi welcomes the TCFD's proposed guidance on Metrics, Targets, and Transition plans; and supports the TCFD's move towards more forward-looking metrics, particularly concerning the inclusion of portfolio alignment metrics for financial institutions. The concept of portfolio alignment is becoming increasingly important as many financial institutions now seek to demonstrate the Paris alignment of their financing activities. Portfolio alignment and implied temperature rise metrics in particular are relatively new concepts and the TCFD's technical supplement provides much needed clarity on how to construct and use these tools.

The SBTi has been consulted by the TCFD's Portfolio Alignment Team as part of the original report on portfolio alignment and as part of the creation of the latest Technical Supplement. This note serves as the SBTi's formal response to the *"Proposed Guidance on Climate-related Metrics, Targets, and Transition Plans",* and will outline how the SBTi views portfolio alignment tools being used in the context of target setting. In addition, we present our feedback on the key judgements and provide our recommendations on constructing transparent and science-based portfolio alignment tools.

2. Feedback on Metrics, Targets, and Transition Plans

The SBTi welcomes the proposed guidance on Metrics, Targets, and Transition plans; and supports the TCFD's move towards more forward-looking cross-industry, climate-related metrics. The SBTi's feedback to the TCFD consultation is summarised as follows:

1. **Cross industry, climate related metrics:** the SBTi advocates that the TCFD follows the criteria set out by the SBTi for reporting GHG emissions. All companies should disclose scope 3 GHG emissions, and if total scope 3 emissions represent more than 40% of scope 1+2+3 then they should be considered material and covered by a target.
2. **Materiality of metrics**: The latest climate science is quite clear about the urgency of the climate crisis and the subsequent societal, economic, and financial disruption that it is expected to cause. Therefore, the SBTi advocates that the disclosure of scope 1+2+3 GHG emissions is material for all companies. The GHG protocol must be followed when companies report their GHG inventory as part of the SBTi target validation process. The completeness principle of the GHG protocol ensures that any definition of a minimum emissions accounting threshold (often referred to as a materiality threshold) is not compatible with the goals of the protocol.

   The SBTi agrees that the state of scope 3 GHG reporting and the resources available to conduct screenings and complete GHG inventories has now evolved sufficiently to warrant its reporting for all companies. Over the past 5 years, the SBTi has now reviewed and approved over 750 companies representing 20% of global market capitalisation. These companies have all disclosed a satisfactory scope 3 GHG inventory which justifies the TCFD moving to advocate for their inclusion in disclosure.

3. **Financed emissions disclosure:** the SBTi also supports the recommendation for financial institutions to disclose financed GHG emissions in line with PCAF recommendations. The PCAF standard is currently recognised by the SBTi as a freely available approach to measure portfolio-wide or asset-level–financed emissions. For financial institutions that are interested in understanding the overall exposure to emissions of their portfolios, the SBTi recommends using PCAF methods to conduct a portfolio-wide emissions screening and prioritize which part of a portfolio to focus on for target setting (i.e., asset classes and sectors). Following this prioritization, financial institutions measure emissions associated with their investing and lending activities to determine the emission baselines from which emission-based SBTs are set.
4. **Portfolio alignment metric recommendations**: The TCFD recommendations for financial institutions on the disclosure of portfolio alignment metrics are timely and relevant.
   a. As acknowledged in the technical supplement, portfolio alignment tools can have many applications. The SBTi recognises their value for target setting at a portfolio level and supports the use of binary target measurement and implied temperature rise metrics in our target setting framework.
   b. While we support the recommendation for Banks, Insurance Companies, Asset Owners, and Asset Managers to measure and disclose the alignment of their portfolios, there remain many challenges in methodological development and standardisation. We believe that the

accompanying technical supplement can be used as an important foundation for discussion and that method developers should focus on greater transparency which will be essential to accurately compare and evaluate methods.

5. **Target setting and disclosure**. The additional guidance in the targets section also highlights the need for companies to report more ambitious and more granular target information, that is regularly updated and classified in terms its alignment with the Paris Agreement. The SBTi target setting framework enables companies to fully align with the new guidance by providing best practise target setting standards for companies to ensure high quality targets can be disclosed and tracked. The SBTi provides a broad set of quantitative and qualitative criteria for companies covering the following key areas:
    a. Base year latest year GHG inventories. The SBTi enables organisations to use any base year but will also measure ambition based on the most recent available GHG inventory.
    b. Timeframe: science-based targets must be mid-term in nature i.e. the target year must be between 5-15 years from the reporting year. Long term GHG reduction targets, and net-zero targets are currently optional but should always be accompanied by mid term (5-15 year) targets.
    c. Ambition of target - the SBTi validation process assigns a temperature rating to all approved companies covering their scope 1+2 targets.
    d. Companies with approved targets must publicly report progress against the targets on annual basis
    e. The SBTi criteria ensures that targets must be reviewed regularly and updated if necessary to stay aligned with the latest climate science, e.g. when new scenarios become available.

3. Portfolio Alignment Feedback

3.1 Portfolio Alignment and Target Setting

The SBTi broadly supports the recommendation for Banks, Insurance Companies, Asset Owners, and Asset Managers on recommended disclosure Metrics and Targets a) to recommend that financial institutions should measure and disclose the alignment of their portfolios. This recommendation aligns with our target setting framework for financial institutions which incorporates portfolio alignment tools to enable financial institutions to set their own portfolio wide targets. As outlined in previous PAT reports[1] and other studies on implied temperature rise metrics[2], there are many alternative methods for generating

[1] Portfolio Alignment Team, Measuring Portfolio Alignment, 2020
[2] Institut Louis Bachelier, et al., The Alignment Cookbook — A Technical Review of Methodologies Assessing a Portfolio's Alignment with Low-carbon Trajectories or Temperature Goal, 2020.

alignment metrics with no clear consensus on how to best interpret and compare the resulting outputs, especially the implied temperature rise metric. As manytools remain “black-box” models, the comparison and assessment of these various approaches has been difficult.

The SBTi uses portfolio alignment approaches to better understand the baseline status of portfolios i.e. which companies in the portfolio can be considered aligned, via their public targets, and which are still misaligned, either because they have no targets to reduce GHG emissions or because their current targets are not ambitious enough. Portfolio alignment tools can be best viewed as generating a portfolio metric, which can then be addressed via a specific target setting method. These portfolio alignment metrics are essential inputs to two of the SBTi’s target setting methods, portfolio coverage and temperature rating. Figure 1 highlights how portfolio alignment tools can be used in the context of target setting.

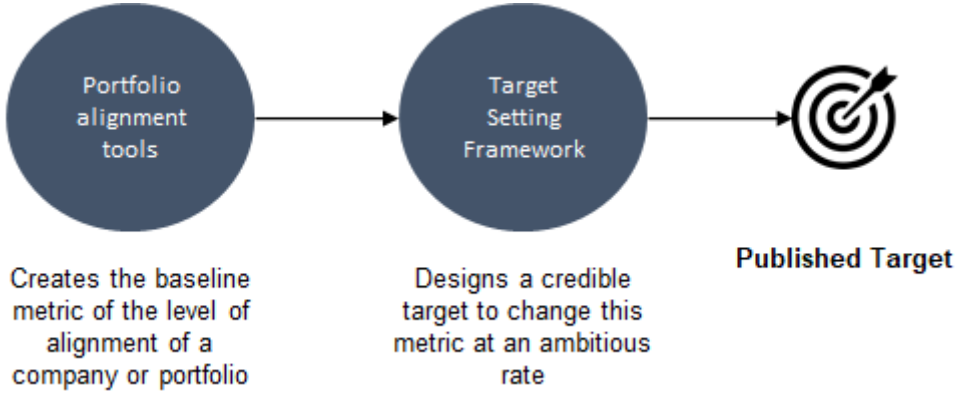

Figure 1. Portfolio alignment tools act as an input for target setting methods.

The TCFD’s technical supplement acknowledges that implied temperature rise metrics are the most sophisticated and complex of all the forward looking measures of portfolio alignment. The sophistication of the models is also dependent on the ultimate goal of the metric. As highlighted in the Proposed Guidance on Climate-related Metrics, Targets,and Transition Plans report, while “*not all metrics will require a target, all targets should be supported by appropriate metrics.*” If the implied temperature rise metric is to be used as a part of a target setting process like the SBTi, the goals of the model may be different if that metric is to be used in other contexts.

As the SBTi's primary goal is to incentivise target setting, we use portfolio alignment tools to create the right incentives to engage companies to set more ambitious targets and hence improve their temperature rating. While there are many applications of implied temperature rise metrics, we believe that they should all follow a common set of design judgements that ensure they are science-based and consistent. Through both the corporate and financial sector framework, the SBTi has developed approaches for each of the 3 methodological steps involved in portfolio alignment methods, detailed in Table 1.

Table 1. SBTi methodological approach for implied temperature rise metrics

Methodological Step	**SBTi Approach**
Step 1: Translating scenario-based carbon budgets into benchmarks	Benchmarks used to evaluate company ambition are derived from credible and relevant scenarios. The SBTi works closely with a Scientific Advisory Group to ensure that the scenarios underlying SBTi methods are appropriate, based on transparent principles, as well as updatable with the latest science. SBT methods are then used to calculate company-specific benchmarks based on a combination of scenario data and company-specific inputs. 1. The SBTi uses a scenario envelope approach to recognize the range of potential transitions aligned with the ambition of the Paris Agreement. Scenario envelopes, which are currently used for the SBTi's global contraction method and benchmarks, are also being developed at sectoral resolution with safeguards to ensure that in aggregate a global emissions budget is not exceeded. 2. These benchmarks are sector specific where possible and currently are available for the most high impact sectors (e.g. power generation, cement, steel, transport). All other sectors are assessed via economy-wide pathways. 3. These benchmarks are applied at a global level, as within regions, there remains major differences between countries. And with many companies being multinational they span many countries and regions, global benchmarks are appropriate. Methods like the sector decarbonisation approach (SDA) accommodate a wide range of starting intensities, thus this method already reflects some location-specific differentiation. 4. These benchmarks are applied to all relevant GHG scopes. 5. The units used to measure alignment are based on physical intensity where possible, using a convergence approach, and absolute emissions using a rate of reduction approach where physical intensity data is not available.
Step 2: Assessing company-level alignment	Companies' GHG emission reduction ambitions are then assessed against these benchmarks to generate a measure of alignment (°C) 1. Reported primary data is used where possible, but can be complemented by modelled GHG emissions data if needed. Companies are assessed on all relevant GHG emission sources, including scope 3 with future projections covering all sources of emissions generated for the company to produce a unit of value added

	2. Determining future performance is most credible in the form of a public GHG emissions reduction target. The SBTi recognises that a target itself is only one aspect of accurately predicting future performance. This has led to a process of tracking performance against these targets which gives more insight into the company's performance. A sample of this work is available in the 2020 SBTi progress report. 3. Alignment, defined by the SBTi, is currently based on a rate of change approach. This is due the benchmarks used and the fact that future performance is currently based only on target ambition.
Step 3: Assessing portfolio-level alignment	The SBTi has developed many weighting approaches that can be used to aggregate company level ratings to produce a portfolio level rating and advocate using approaches that include an emissions ownership approach. These include options to aggregate based on revenue and total assets in addition to validation measures such as enterprise value.

3.2 Technical Supplement Feedback

The technical supplement clearly articulates the design considerations and the challenges associated with generating implied temperature rise metrics. The SBTi fully supports the goals of ***promoting more widespread adoption of consistent, robust, and decision-useful approaches.*** As a user of implied temperature rise metrics, the SBTi would like to see more transparency across method developers in order to better evaluate methods for their inclusion in target setting methods.

The supplement reveals that the benchmark construction phase can be the most complex aspect of constructing a portfolio alignment tool. Regardless of the approach taken, warming functions or single scenario benchmarks, more needs to be done to improve the transparency of this step. The supplement also rightly points out that benchmarks should be as granular as possible and updated on a regular basis.

The TCFD's recommendations are a necessary and welcome step to improving their credibility and wider acceptance. While the recommendations do help to provide clarity and tools to drive convergence, the recommendations to build single scenario, intensity based benchmarks are not supported by sufficient evidence to be considered science-based and could cause the misrepresentation of companies and portfolios in terms of their alignment to the Paris Agreement. The SBTi is primarily concerned with recommendations outlined as part of Judgements 1 and 3, and their implications for the evaluation of companies.

The first judgement recommends single-scenario benchmarks over warming functions built on multiple scenarios. As described in the SBTi Foundations of Science-Based Target Setting paper, the initiative uses an enveloped approach to identify pathways and scenarios aligned with Paris Agreement temperature

outcomes. Building on this approach, the SBTi is performing an emissions corridor assessment of the IEA's recent Net-Zero 2050 scenario to assess ambition and compatibility. The third judgement, which recommends the use of intensity based benchmarks is also of concern as it will mean the reliance of economic intensity approaches to assess most companies. Finally, while we acknowledge that there are many approaches to assessing future performance of companies, we recommend that methods should still seek to incentivize companies to publicly report GHG emissions and targets.

1. **Single-scenario benchmarks are highly sensitive to normative methodological decisions.**

   The technical supplement first highlights that benchmarks can be constructed by using a single scenario approach or via a warming function which is built using input from multiple scenarios. The SBTi has used both single scenario approaches (via the Sector Decarbonisation Approach which relies on IEA ETP scenarios) as well as a scenario envelope approach for global absolute contraction. When assessing all other public targets, multiple scenarios are used to create a warming function to best capture how companies report their intended future performance (via targets).

   Recommendation 5 for Judgement 1 advocates the use of a single scenario benchmark over the use of a warming function. The justification provided for the recommendation of a single scenario over the use of a warming function is that they are "simpler to implement, easier to interpret, and more transparent with regard to assumptions and their effect on results". We acknowledge that warming function based benchmarks are by design more complex to construct and can be perceived as being less transparent compared to single scenario benchmarks. However, what the warming function approach lacks in transparency, it makes up for in stability. The reason a multiple scenario approach is preferable is that the resulting function is very insensitive to which scenarios are included as it is derived from qualities of the entire modeled scenario landscape. Using a multiple scenario approach, based on a strict set of science-based criteria can help ensure less sensitivity and bias in the final benchmarks.

   The choice of scenario is one of the most sensitive parameters to determining the ultimate alignment of a company, the harmonization of methods, and the benchmarking between ratings. Hence, a single scenario approach may lead to even greater divergence between method developers which is contradictory to the objectives of the report. The SBTi's foundation of science based target setting paper, outlines that scenarios should not be considered as predictions, and the future may be represented by more than one scenario. Therefore the freedom to choose just one scenario from a range of scenarios opens up the possibility of 'cherry picking'. Benchmark construction must be objective and must prioritize responsible scenarios that minimize climate risk, regardless of whether this scenario is preferable to one specific organization or sector. Ideal scenarios are therefore defined in terms of a number of key principles based on plausibility, responsibility, objectivity, and consistency. Box 1 in the foundations paper (p. 10) describes these principles in more detail.

The SBTi believes that recommendations on benchmark construction should aim for a robust, stable function built on a common set of credible scenarios as a priority, but to use a single scenario approach if a scenario envelope method is not possible. We believe that it is important that all method developers use a common set of principles and ideally choose a consistent set of scenarios in an effort to make the results more comparable. Wildly diverging outcomes caused by different scenario selections would reduce trust in these metrics. One of the SBTi's primary functions is to evaluate scenarios and incorporate them into benchmarks that enable companies and financial institutions to set Paris-aligned targets. This process has provided clarity, confidence, and trusted temperature ratings.

Our key recommendations:

1. **Hierarchy approach to benchmark construction.** Multiple scenario approaches should be used when available, and single scenario benchmarks should only be constructed when there is a lack of multiple credible scenarios.
2. **Create clear scenario characteristics:** Ensuring convergence in approaches to benchmark construction will mean method developers must use a consistent set of principles to select suitable scenarios. In addition to the principles outlined above, there can be a number of normative reasons to prefer certain scenarios over others e.g. potential climate impacts of overshoot, and the feasibility of large scale CO2 removal. The SBTi has conducted a significant amount of research and analysis on IPCC and other scenarios and can offer this as a public solution akin to an open source database on the principles for scenario selection.

   Cherry picking scenarios that may suit a specific portfolio is an inherent risk when recommending single scenario approaches. Therefore, we believe that a stricter list of recommendations are needed to ensure that the scenarios used are science based and can allow suitable comparison across method developers, with single scenario benchmarks only being used when there are no other alternatives.

2. Allocating global emissions based on economic growth yields incoherent results

Recommendations 6 and 9 focus on the type of benchmarks that can be constructed (convergence vs. contraction) and the units of the benchmark, respectively. The supplement recommends convergence benchmarks over the use of rate of change (contraction) based approaches to "avoid unfairly penalizing high-performing companies", as a contraction based approach would require all companies to reduce emissions at the same rate, regardless of their previous performance.

The SBTi agrees that convergence approaches should be used where possible, as they do reflect better on how a company is performing relative to its peers, and is in general better for companies with rapidly changing market share. The SBTi currently uses a physical intensity based convergence

approach as part of its SDA method. However, when looking at all companies approved via the initiative, over 85% of those companies cannot be assessed using a physical intensity approach as they do not have a consistent homogeneous production unit on which to assess performance. The recommendation to use intensity based convergence will therefore mean heavy reliance on economic intensity based approaches as most companies will not have a consistent homogenous physical output on which to evaluate their performance. Diversified, multi-sector, multi-region portfolios will also be expected to contain a majority of companies who cannot be assessed on the basis of physical intensity.

The incoherent results and incentives for companies depending on their rate of economic growth is a major concern for constructing benchmarks. The SBTi has also identified a number of other key concerns with using economic intensity:

- Allocating global emissions based on economic performance can yield incoherent results as economic based benchmarks follow the principle that a company's absolute emissions reduction should be smaller the more it is expected to increase its economic performance. Fast-growing sectors, and faster growing companies within the same sectors, would be expected to reduce emissions at a slower rate than slower-growing sectors, or slower growing companies within the same sector. This means that some sectors which are growing their revenue faster than the market average like software[3] would be expected to decarbonise at slower rates. However some of these fast growing sector's emissions are dominated by electricity which in nearly all climate scenarios is expected to decarbonise faster than global emissions. All-in-all, this can lead to an increase in absolute emissions globally and illustrates the acknowledgement in the technical supplement that economic based intensity approaches can lead to an "underestimation of warming potential"
- A reliance on intensity based benchmarks can also fail to capture much of the demand-side mitigation that is needed to limit warming to 1.5C. In the recent IEA-Net-Zero[4], material efficiency, transport mode shifts, and other behavior changes account for a similar share of mitigation as the entire buildings sector (and significantly more than iron & steel, chemicals, or cement). While intensity based approaches have clear benefits for supply-side companies, they appear insufficient for demand-side companies and financial institutions due to the critical importance of demand-side mitigation actions—including behavior change.
- Economic intensity indicators (e.g. tonne of CO2 / profit) are also subject to a number of variables that can lead to apparent changes in a company's carbon intensity that have nothing to do with its environmental performance, but rather with extrinsic factors. Examples of this include the fluctuation of commodity prices, market demand, inflation, or changes in a company's business mix. The report acknowledges that changes in economic performance can obscure real decarbonization and suggests that benchmarks should be updated regularly to avoid this. While regular benchmark updates are crucial, the ability to update benchmarks at the frequency required to to avoid these problems needs to be further assessed.

[3] Damodaran, A. (2021, July 07). Historical (Compounded Annual) Growth Rates by Sector. Damodaran Online. http://pages.stern.nyu.edu/~adamodar/New_Home_Page/datafile/histgr.html

[4] International Energy Agency, Net Zero by 2050 A Roadmap for the Global Energy Sector, 2021

The supplement highlights the importance of focusing the discussion of benchmark units on what is most “methodologically feasible”. Economic intensity can certainly be considered the most feasible with economic data being widely available. However, it is also acknowledged that the “units used to measure alignment against a benchmark will have direct implications for the incentives communicated to companies”. A reliance on economic intensity approaches can incentivise the wrong types of actions. The SBTi believes that in addition to the wide coverage, the benchmark’s primary function is to ensure a credible evaluation of a company based on appropriate and necessary absolute emission reductions. Ultimately, a reliance on economic intensity approaches may incentivise companies to increase economic performance, but not sufficiently address their absolute emissions. The most important reason for why this matters is that many portfolios will contain a significant share of companies who would have to be assessed using economic intensity units. Therefore, the assessment of their alignment may entirely fail to get us the result we are seeking, and may misrepresent the performance of companies in terms of alignment with a 1.5C world. Implementation of these recommendations may lead to the case where fast growing companies are evaluated as being Paris aligned but their actual GHG emissions are increasing.

Our key recommendations:

1. **Hierarchy approach:** The SBTi recommends that convergence benchmarks should only use units of physical intensity. We therefore support the recommendation to prioritise physical intensity based convergence approaches where possible. Due to the issues outlined above with economic intensity based convergence, avoiding this approach will mean prioritising rate of change benchmarks for cases where physical intensity is not suitable.
2. **Rate of change benchmarks:** Rate of change approaches assess companies based on their forward-looking ambition rather than the prior actions the company has taken to reduce emissions. This naturally penalizes those companies that have already reduced emissions considerably, since generally the cost of emissions reductions for most companies will increase as low-cost/high-return options are exhausted. As rate of change benchmarks can help to ensure a more science-based assessment, methods to overcome unfairly penalizing high-performing companies should be a priority.

   The approaches outlined as part of judgement 6, “How do you project company performance?”, could be used to ameliorate the weaknesses inherent in rate of change based approaches. Rate of change based approaches could use a combination of forward-looking and backward-looking indicators to provide more company specific assessments that would better reflect the current performance of a company relative to its peers. This would mean that companies with the same absolute emission reduction targets, but who have different rates of past reductions would not receive the sample temperature rating. While combining these approaches need further testing, we believe that the TCFD can acknowledge these approaches as part of the technical supplement to highlight that rate of change benchmarks can be constructed in a manner that avoids unfairly penalising companies.

3. Projecting future performance should incentivise companies to disclose targets

Recommendation 16 proposes that forward-looking projections of company performance not be based solely on targets. We agree that projections based on measures other than forward-looking ambition can be useful and necessary to achieve sufficient coverage in any portfolio. The overall level of target disclosure remains low, particularly when it comes to scope 3, and portfolio alignment tools should still aim to incentivise companies to disclose more primary data on their current performance and projected future intentions so as to integrate GHG reductions into corporate strategic management.

Third party validated targets with annual reporting will help ensure that these targets can incentivise the necessary real world reductions. Incentivizing good target-setting behavior but not actual emissions reductions should only occur in the cases where companies' performance against those targets is not tracked. The SBTi's research[5] has shown that companies with approved SBTs are reducing their emissions at the required rates and are being held accountable via annual disclosure and progress tracking. While this does not imply that all companies will always meet their targets, it does emphasise the target setting is vital, and other measures of projecting future performance should have the secondary aim of either measuring existing target alignment or encouraging the company to set a target.

A complete measure of alignment of a company against a specific temperature goal would require more than a forward-looking target. Moving beyond targets however is also a major challenge. As with selecting appropriate scenarios for benchmark construction, the question remains how to credibly incorporate other projections approaches in order to not create diverging temperature ratings between method providers.

4. Conclusions

Portfolio alignment tools will continue to increase in importance as more financial institutions seek to undertake forward-looking assessments to align their financing activities with the goals of the Paris Agreement. The SBTi therefore welcomes the Portfolio Alignment Team's report on the building blocks and approaches to creating these portfolio alignment tools. With this note, we have aimed to provide more clarity on how the SBTi uses portfolio alignment metrics as part of the target setting process.

We have also outlined three issues of concern identified in the proposed recommendations centring on 1) benchmark construction, 2) benchmark units, 3) projecting future performance. We have highlighted that implementing the recommendations in their current form could lead to a greater divergence in the resulting temperature rise outcomes due to selection of single scenarios, rather than applying a more stable multiple scenario approach. We have also stressed that these recommendations will lead to an over reliance on economic intensity based approaches to construct benchmarks, which can dis-incentivise the right action and potentially misrepresent the alignment of companies and portfolios.

[5] SBTi Annual Progress Report, From Ambition to Impact - How companies are reducing emissions at scale with science-based targets, 2021

We welcome further engagement with the Portfolio Alignment Team and method developers to ensure that consistent and credible approaches to benchmark construction and company assessments can be undertaken. This will be essential to providing the trust and certainty required of portfolio alignment tools to ensure their wider adoption and uptake.