July | 2023

How asset managers can set interim net zero targets that are fit for purpose

Responsible Investment Standards & Expectations - Guidance Paper #1

ShareAction»

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ShareAction is an NGO working globally to define the highest standards for responsible investment and drive change until these standards are adopted worldwide. We mobilise investors to take action to improve labour standards, tackle climate change and address pressing global health issues. Over 16 years, ShareAction has used its powerful toolkit of research, corporate campaigns, policy advocacy and public mobilisation to drive responsibility into the heart of mainstream investment. Our vision is a world where the financial system serves our planet and its people.

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Acknowledgements

ShareAction would like to thank Catherine Howarth OBE, Peter Uhlenbruch, Simon Rawson, Stuart Laidler, Emma Robertson, Katie Stewart, Melanie Kramers and Sam Coates (all ShareAction staff).

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Introduction

Introduction

Finance is critical to powering action to meet globally agreed climate targets and the Sustainable Development Goals. Yet currently too little finance is being responsibly deployed, leading to a world where people face increased hardship due to inequality and devastating climate change impacts. To ensure that finance is driving action to tackle social and environmental challenges at the scale and pace we urgently need, ShareAction is urging the investment community to align with its ambitious new definition of responsible investment.

"Responsible investment is a transparent approach, embedded throughout the investment process, that takes the negative and positive impacts on people and planet as seriously as financial risk and return."

ShareAction is supporting the investment community to meet this ambition by releasing a series of guidance papers that will set out **Responsible Investment Standards & Expectations (RISE)** for asset managers across specific topics. This guidance, grounded in detailed research, recommends actions that asset managers can – and should – take in today's investment environment in pursuit of being a truly responsible investor. This guidance can also be used by asset owner clients, investment consultants and other stakeholders to inform their interaction with asset managers.

This guidance paper, the first in the series, addresses asset managers' interim net zero targets, which are critical to ensuring that companies are decarbonising at the pace and scale needed to limit global heating to 1.5°C. Setting robust targets is a necessary step to 1.5°C, anchoring asset managers' commitment to the goal with clarity and providing accountability on their progress towards it. It is, however, only the first step. Achieving the decarbonisation goal will also require ambition from portfolio companies, engagement by asset managers' clients, and supportive regulation for asset managers' targets to be met. That's why ShareAction is also pushing for government action to ensure that the regulatory environment is able to unlock the full potential of finance to address harmful impacts on people and planet. This ranges from mandatory transition plans for all large companies to widening the concept of 'best interests' in fiduciary duties, so that social and environmental factors are considered alongside financial return.

Society needs this responsible approach to investing to become the norm. We hope that all those in the investment community who share our vision of a world where the financial system serves our planet and its people will use these RISE guidance papers to play their part in driving the bold, ambitious changes that people around the world are calling for.

How to use this report

This report and its recommendations are designed to help key stakeholders in the financial community to understand:

- The crucial role that interim net zero targets can play in decarbonising the global economy; and
- The ways that these targets should be strengthened and standardised for capital to be an effective catalysing agent for that decarbonisation.

Asset managers should use this report and its recommendations to strengthen their interim net zero targets, improve disclosure to their clients and other stakeholders, and to advocate for these robust standards across industry forums.

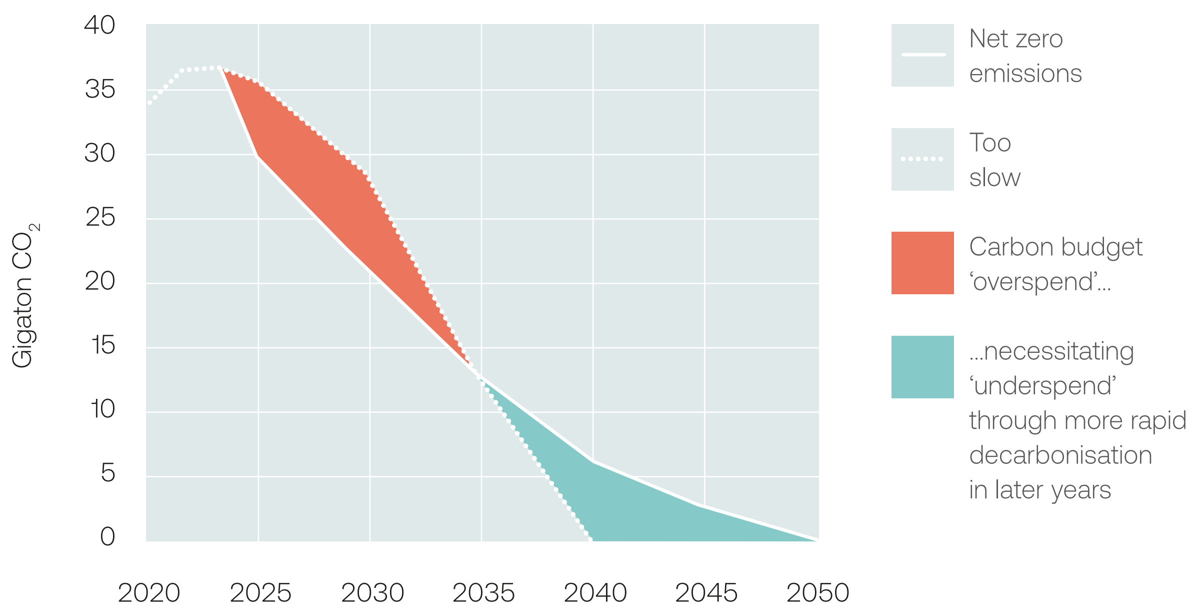
Asset owners and **investment consultants** can use this report and its recommendations to challenge asset managers on whether their interim net zero targets genuinely correlate with their Net Zero Asset Managers initiative (NZAMI) or other commitments to a net zero goal, by requesting responses to each of the Expectations set out in this paper.

Why interim net zero targets are so critical

The Intergovernmental Panel on Climate Change (IPCC) – the leading global authority on climate science – is clear that it will only be possible to limit the rise in global temperature to 1.5°C if we meet critical milestones to reduce emissions along the way. The journey is as important as the destination.

Interim net zero targets are a vital checkpoint on that journey to ensure we are not exceeding the carbon budget for each stage – the maximum cumulative emissions allowed if we're to stay on track to meet the 1.5°C goal. The IPCC sets out the requirement for a 43% reduction in global greenhouse gas (GHG) emissions and a 48% reduction in CO_2 emissions by 2030 (against a 2019 baseline) to ensure we don't overshoot a 1.5°C rise in global heating.
If we fail to reduce emissions enough to meet these 2030 targets, then our global deadline to reach net zero will be brought forward. Overspending our carbon budget in the near-to-medium term would significantly steepen the challenge we face in achieving a 1.5°C future.

Figure 1: Annual emissions in NZE versus a slower decarbonisation ("Too Slow") scenario



The role of the financial sector in this is absolutely critical. While it is companies that must deliver emission reductions across their activities by decreasing their direct or indirect carbon footprint, their investors, through the agency of their asset managers, can pull important influential levers to ensure this happens. Asset managers can, and should, use the full range of levers at their disposal in allocating and stewarding capital to influence the companies in their portfolio to reduce emissions in line with net zero goals. As such, stakeholders can place meaningful expectations on the commitments that asset managers make through their interim net zero targets.

Climate risk is increasingly understood as economic risk, and therefore asset managers have a financial as well as a moral basis for embracing the potential influence they could choose to wield over the companies they invest in and fund on behalf of their clients. Just as they target a share in the financial rewards of portfolio companies, so asset managers must accept their indirect responsibility for those companies' emissions and actively manage the long-term financial risks these emissions pose.

The current state of interim net zero targets

Despite the crucial role they could play, asset managers are not yet adequately harnessing this huge potential influence. ShareAction's latest biennial Points of No Returns survey of 77 of the world's largest asset managers found that asset managers' net zero ambitions are falling short of what is needed.

We also assessed whether targets set by the 65 largest[1] asset manager signatories to NZAMI were in line with the 1.5°C transition pathway upon which their commitment to the initiative was based. We found that asset managers vary greatly in their approach to target setting. This lack of standardisation makes it difficult for clients, regulators and the public to track and compare progress and hold asset managers to account. The current targets create the potential for material divergence from their commitment, as NZAMI members, to deliver net zero aligned with a 1.5°C pathway. This risks undermining confidence in the sincerity of these commitments and increases the scope for greenwashing.

1 Defined as asset managers with AUM above US$100bn with interim targets disclosed as of the NZAMI November 2022 update.

With 291 asset manager signatories representing US$66 trillion assets under management (AUM) at its November 2022 update, NZAMI's significant scale means it has the potential to be a powerful force driving coordinated, urgent action by finance to tackle the climate crisis. NZAMI requires its members to implement their shared commitment to:

"support the goal of net zero greenhouse gas (GHG) emissions by 2050, in line with global efforts to limit warming to 1.5°C... [and] to support investing aligned with net zero emissions by 2050 or sooner"

through:

"set[ting] interim targets for 2030, consistent with a fair share of the 50% global reduction in CO_2 identified as a requirement in the IPCC special report".

Interim net zero targets that robustly capture this commitment will provide an effective mechanism for decarbonising the global economy. This will be an important step in establishing public trust in the credibility and sincerity of asset managers' commitment to contribute to the transition to net zero.

Signatories are required to provide transparency (including publishing an annual Task Force on Climate-related Financial Disclosures report and climate action plan) and collaborate with asset owner clients on decarbonisation goals.

Active stewardship of portfolio companies is a core feature of the commitment, requiring asset managers to:

"implement a stewardship and engagement strategy, with a clear escalation and voting policy, that is consistent with our ambition for all assets under management to achieve net zero emissions by 2050 or sooner".

Summary of expectations

Summary of expectations

The current structure of the interim net zero targets has the potential for material shortfalls in meeting the 50% emissions reduction goal which is the bedrock of the NZAMI commitment.

We believe the expectations below should be part of an approach to **standardised target setting.**

- **Problem:** Currently, targets are heterogenous, at the cost of clarity, which risks undermining confidence in asset managers' commitments to support decarbonisation. Coalescing around a narrower, more robust set of target methodologies would improve clarity and engender greater confidence that asset managers' net zero commitments genuinely align them with their stated 1.5°C goal.
- **Expectation #1:** Advocate for a common approach to emission reporting and interim target setting.

Based on our in-depth assessments of the interim targets of the 65 largest asset managers disclosed through NZAMI, **we believe that asset managers should strengthen their interim targets in the four following areas:**

A. Asset coverage

- **Problem:** The asset managers who have set and disclosed targets have so far only committed a minority (39%) of their total AUM to those targets, on average. This low portion of asset coverage leaves the majority of their assets unconstrained by their target commitment.
- **Expectation #2:** Underpin the commitment to increase covered assets to 100% of AUM by enhancing transparency:
  - Provide a breakdown of uncommitted assets, including the rationale for exclusion.
  - Disclose the process, progress and expected timeline for inclusion of uncommitted assets.
  - Give an indication of how significant the emissions from uncommitted assets are, compared to those of committed assets.
  - Report and set targets for gross direct corporate emissions separately from net total emissions.
  - Disclose the use of and rationale for portfolio-level offsets and commit to disclose aggregate company-level offsets over time.
  - Commit to the adoption of Scope 3 emissions on a commonly agreed timeline.

B. Target construction

- **Problem:** The decarbonisation mandate requires a reduction in absolute (i.e. actual, real-world) emissions. Only absolute targets necessarily correspond to that mandate. But most asset managers use alternative – and potentially weaker – targets, such as intensity-based emissions or portfolio coverage approaches.
- **Expectation #3:** Report and set targets on absolute emissions as the primary metric.

C. Portfolio composition

- **Problem:** Decarbonising the global economy will require significant effort to transition existing high-carbon companies into adopting low-carbon technologies and processes. Asset managers simply shifting their portfolios out of high-carbon sectors into low-carbon sectors may reduce their individual portfolio's carbon footprint, but this will not lead to the radical reduction in emissions that is needed to transition the real-world economy to net zero.
- **Expectation #4:** Place real-world impact at the heart of net zero targets and evidence this by disclosing the underlying contribution from portfolio companies to progress on emission targets:
  - Attribute year-on-year emission changes to: perimeter effect (net inflows/outflows); compositional impact (changes in portfolio exposures); and underlying portfolio company decarbonisation (like-for-like).

D. Target ambition

- **Problem:** The 50% emission reduction target is a global average. Companies in the Global South will need to decarbonise more slowly than those in the Global North, as they contend with higher underlying demand growth and lower access to capital. For the world to meet the 50% reduction target by 2030, companies in the Global North will need to decarbonise ahead of that global average.
- **Expectation #5:** Calibrate target ambition to reflect the geographical mix of the portfolio, with greater ambition for Global North exposure.

Expectations in detail

Expectation #1: Advocate for a common approach to emissions reporting and interim target setting

Diversity of geography, strategy, asset class mix, regulation and clients across the asset manager community makes a unified approach to target setting difficult. Measuring and setting targets on emissions is a highly complicated exercise. Asset managers do not lend their reputations to these commitments lightly. As a result, it is understandable that their initial steps into target setting have been tentative and guidance from NZAMI accommodative. It was important to get a critical mass of asset managers started on their net zero journeys rather than to require a rigid approach to target setting at the outset.

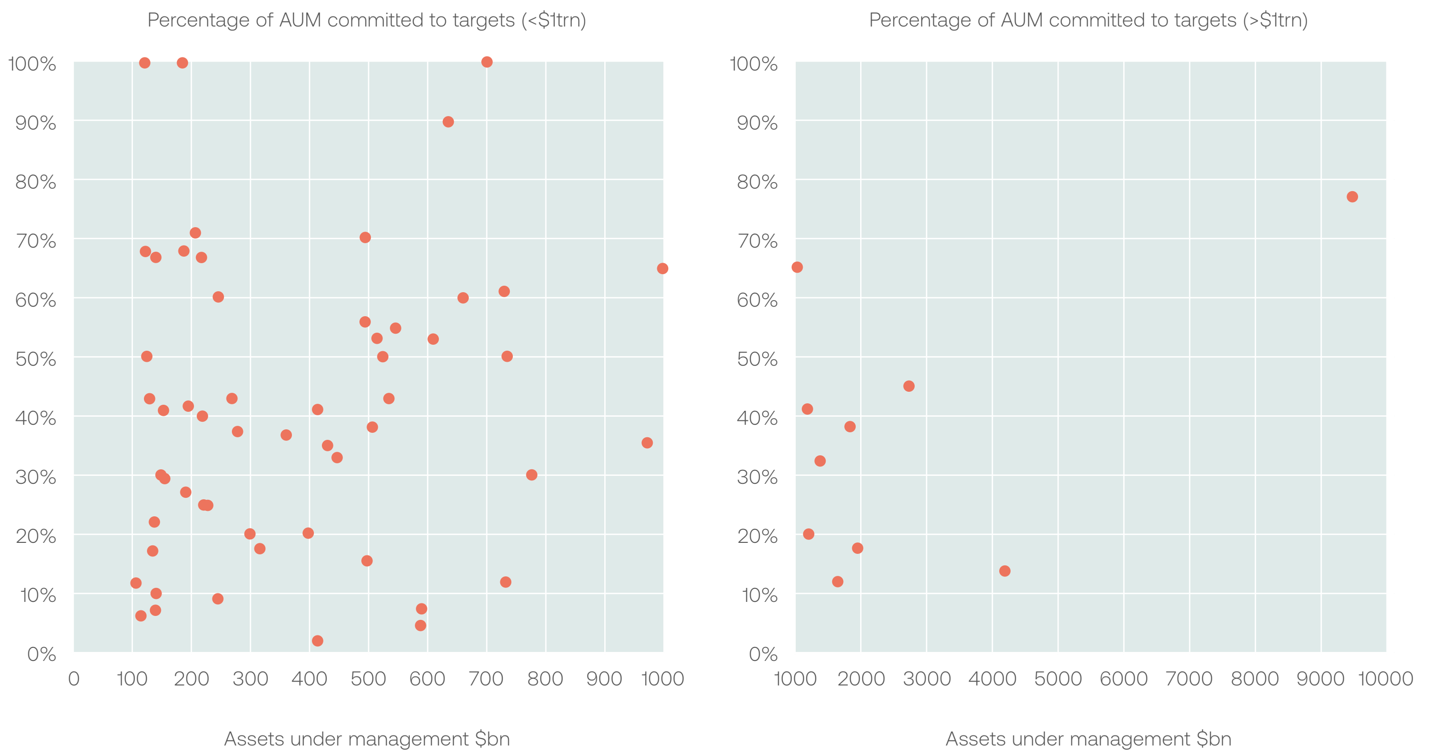
Nevertheless, giving broad flexibility on methodological approach and interpretation risks undermining confidence in the sincerity of asset managers' intent and hinders accountability. The absence of methodological standardisation also weakens the collaborative potential of asset managers within initiatives such as NZAMI in pursuing the decarbonisation goal.

Asset managers should be clear that interim targets are a process of evolution and acknowledge that the first forays into interim target setting contain potential shortfall risks against the goal of a 50% global emission reduction. Asset managers need to advocate for a harmonised approach to strengthening interim targets with methodologies which are securely anchored to the 50% emission reduction goal.

Expectation #2: Underpin the commitment to increase covered assets to 100% of AUM by enhancing transparency

The 169 asset managers who had set interim targets as of NZAMI's November 2022 update committed 39% of their AUM to those targets, on average, meaning that the majority of these managers' AUM remains unbound by target commitments. The wide dispersion of committed assets – ranging from 2% to 100%[2] – illustrates asset managers' radically differing interpretations of how to honour their net zero commitments. Put simply, only committing a minority of assets to targets leaves a clear risk that targets can be met while the portfolio overall comes up materially short of a 50% emission reduction.

Figure 2: Portion of AUM committed by asset manager



The reasons why assets remain uncommitted are not trivial. Emissions data, while rapidly improving, remains incomplete. Methodologies for measuring and attributing emissions for non-corporate asset classes are still being developed and agreed. And there is a fundamental debate around whether net zero commitments can be made on behalf of clients without their explicit approval. (This debate boils down to whether the rationale for 1.5°C is economic as well as environmental, and can therefore be captured within the default boundaries of fiduciary duty.)

Expectation #2.1: Provide a breakdown of uncommitted assets, including the rationale for exclusion

Currently, it is not straightforward to assess the various interpretations and approaches across asset managers due to a lack of sufficient, standardised disclosure on the composition of uncommitted assets and the reasons for their sitting outside the target scope. To facilitate meaningful comparison of target integrity, asset managers should provide an explicit breakdown of uncommitted assets (by asset class, geography, sector) and the basis for their exclusion from targets (data, methodology, client approval or a combination of these).

Expectation #2.2: Disclose the process, progress and timeline for inclusion of uncommitted assets

Under their NZAMI commitments, asset managers are expected to ratchet up their committed assets to 100% of AUM. Asset managers should provide transparency on this 'ratcheting' by outlining the process for increasing committed AUM (improving data, identification of common methodologies, securing client approval), the progress made (including contribution to working groups for methodology development, the portion of clients from whom approval has been sought together with the 'success rate') and potential timeline for increasing committed assets (which would enable asset manager commitments to be converted into a meaningful picture of their real-world emissions trajectory).

Expectation #2.3: Indicate the significance of emissions from uncommitted assets compared to committed assets

As well as the composition and cause of uncommitted assets, asset managers should disclose the estimated emissions of those assets so stakeholders can assess the correlation between portfolio targets and real-world emissions trajectory. The robustness of those estimates will vary, from:

high confidence on data for corporate assets which are uncommitted for client approval reasons

to:

lower confidence for asset classes where methodologies are being finalised or data is still being collected.

Expectation #2.4: Report and set targets for gross direct corporate emissions separately from net total emissions

In essence, all emissions originate from corporate entities if looked at through a Scope 3 lens (which would cover emissions produced by suppliers and customers including households and other non-corporate entities). Thus the obligation to reduce emissions ultimately falls on corporate entities (with capital, policy, customers and suppliers all potential influencers).

Reporting and setting targets for emissions across a portfolio could include emissions associated with non-corporate assets (such as sovereign bonds) or involve some exposure netting (for instance from index, swap, derivative or other portfolio hedges). Asset managers should isolate and separately report the total gross emissions of all direct exposures to corporates (public and private, debt and equity) within the portfolio. This will give greater visibility over the part of the economic system that has primary, direct responsibility for reducing emissions – corporate actors.

To strengthen target connection to the real economy, interim targets should reference gross corporate direct emissions as well as net total emissions.

Expectation #2.5: Disclose the use of, and rationale for, portfolio-level offsets and commit to disclose aggregate company-level offsets over time

While offsets can play a limited role in decarbonisation, it is well understood that they pose concerns around quality, permanence, authentication, impact-timing, additionality and capacity, as well as potential adverse social and local community impacts. Feasible direct decarbonisation actions should always take priority over the use of offsets.

Therefore, asset managers should include in their reporting clear identification of their own use of, and rationale for, offsets at the portfolio level (including verification that the offsets are long term, of robust quality, and were used in the absence of viable alternatives).

Further, it is important to understand the extent to which portfolio companies are using offsets in place of direct emission reductions. Therefore asset managers should endeavour to disclose the aggregate use of offsets by their portfolio companies – and engage with companies to provide this information where they are currently not doing so.

Expectation #2.6: Commit to the adoption of Scope 3 emissions on a commonly agreed timeline

Scope 3 captures the lifecycle of emissions and the potential for companies to influence decarbonisation across their value chain. Both the availability and quality of Scope 3 data are improving. Asset managers should commit to incorporating Scope 3 emissions into reporting and targets over a commonly agreed timeline, for example by following the Paris Aligned Investment Initiative Net-Zero Investment Framework (PAII NZIF) guidelines.

Expectation #3: Report and set targets on absolute emissions as the primary metric

Limiting global temperature rise to 1.5°C requires a reduction in absolute – or actual, real-world – emissions, which means that only absolute targets necessarily align with that mandate. Yet only a small minority of asset managers set absolute emission targets. Portfolio coverage and intensity-based target approaches can be useful as supplementary disclosures and target metrics, but they are inadequate as the sole primary target method. Using the wrong metric for targets risks achieving the wrong outcome.

The portfolio coverage approach only offers an indirect link to emissions and does not facilitate assessment of the portfolio's adherence to a 1.5°C pathway, because there is no constraint placed on the emissions of all categories below the category[3] of 'aligned'. It is impossible to gauge the emission trajectory of those sub-'aligned' assets. This approach also underplays the capital allocation lever by emphasising engagement. We estimate that to correspond to a 50% emission reduction, portfolio coverage targets would need to be more ambitious than is currently the case – setting a minimum 75% threshold for 'aligned' assets. None of the assessed portfolio coverage targets currently match this necessary level of ambition.

Intensity metrics introduce a denominator distortion which can obscure what is happening to emissions themselves. Actual emissions could increase, yet the intensity metric would decrease if the denominator (usually revenues of a company or value of a portfolio exposure) increases by more. Intensity metrics are not just potentially misleading, they can (as in this example) be directionally wrong.

Further, this distortion is directionally biased because prices of goods or assets (a significant component of the denominator) generally rise over time. This serves to diminish target strength – for instance, a 50% 2030 intensity target could be achieved through absolute emissions reduction of less than 40% if annual inflation was 2% per annum. As we highlighted at the outset, missing the 2030 emission goal even by 10% is not immaterial – it would cause an over-consumption of the carbon budget, making the post-2030 path to net zero much harder.

The common reasons given for using intensity or portfolio coverage targets – volatility, comparability, facilitating growth, agency – confuse the primary purpose of setting interim net zero targets to align with a 1.5°C goal. Only using absolute emissions as the primary approach necessarily corresponds to that goal.

Expectation #4: Evidence real-world impact by disclosing underlying contribution from portfolio companies to emission targets

Portfolio decarbonisation will need to correlate to real-world impact if asset managers are to genuinely contribute to addressing the global climate crisis. An orderly, 'Just Transition'[4] will most effectively be achieved by retaining the production and manufacturing expertise of many of today's high-carbon companies while moving their footprint to low-carbon models on a 1.5°C pathway. These companies will need to retain access to capital and an engaged investor base. Therefore, a wholesale shift away from high-carbon sectors into low-carbon sectors could undermine the balance of a transitioning economy, hindering rather than catalysing the decarbonisation effort. Asset managers can seek to link their portfolio decarbonisation efforts with real-world impact by actively under-weighting or divesting from high-carbon companies that are lacking in ambition or ability to transition, and reallocating that capital, with focused and clear engagement on transition expectations, to companies or sectors with appropriate ambition.

Asset managers should be transparent on how they are achieving their emission targets and disclose the contribution from their portfolio companies to portfolio decarbonisation. This can be done by attributing changes in emissions across:

1. Net fund inflows or outflows (perimeter effect);
2. Changes in the portfolio (composition effect); and
3. Underlying change in emissions from portfolio companies (like-for-like decarbonisation).

This last category is where real-world emission reduction will come from, and therefore should be clearly disclosed and prioritised. This transparency would enable stakeholders to gauge the prominence that asset managers place on real-world impacts from their target strategy.

Expectation #5 – Calibrate portfolio target ambition to reflect the geographical mix of the portfolio

The NZAMI commitment enshrines the concept of a 'fair share' contribution to the 50% CO_2 emission reduction goal. But that 50% reduction is a global average. Companies in the Global North will need to decarbonise more quickly than average to accommodate the slower pace expected from companies in the Global South, who have to contend with faster underlying demand growth and less access to transition capital.

Portfolios that are weighted to the Global North therefore need to accept target ambition that goes beyond the global average goal of a 50% emission reduction.

Conclusion

While important progress has been made, interim net zero targets are not yet securely anchored to the goal of a -50% reduction in emissions by 2030, which is a critical milestone for a 1.5°C pathway. Target setting is complex and asset managers are being rightly thoughtful in the commitments they are making.

But time is running out for an effective response to the environmental and financial risks posed by climate change. It is time to harmonise and strengthen interim targets in order to provide clear sight on the 1.5°C goal – for all stakeholders, not least portfolio companies - and to enhance transparency so that progress can be confidently assessed.

We believe the recommendations in this guidance paper provide a practical and implementable framework for achieving this, and we look forward to working with investors to make this a reality.

References

1 Of asset managers with AUM > US$100 billion

2 As defined in the Net Zero Investment Framework, which can be found at iigcc.org/download/net-zero-investment-framework-implementation-guide/?wpdmdl=4425&refresh=64942ec970bb31687432905

3 A fair and inclusive process that prioritises the social needs of workers, communities, consumers and citizens affected by the transition to a net zero economy. See a detailed overview at https://www.ilo.org/global/topics/green-jobs/WCMS_824102/lang--en/index.htm [5]

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Registered Charity Number: 1117244

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