Introduction to Commitments and Measurement Methods for Private Financial Sector Portfolio Alignment with the Paris Agreement

Summary for Policymakers

Jochem Wissenburg (Ministry of Finance, Netherlands), Emma Dalhuijsen (World Bank), Florencia Baldi (Financial Centers for Sustainability - FC4S), and Samantha Power

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Authors and Acknowledgements

This summary note was co-authored by Jochem Wissenburg (Ministry of Finance, Netherlands), Emma Dalhuijsen (World Bank), Florencia Baldi (Financial Centers for Sustainability - FC4S), and Samantha Power (World Bank) under the direction of the Co-Chairs of the Coalition of Finance Ministers for Climate Action, Pekka Moren (Finland) and Masyita Crystallin (Indonesia), the Lead of the Helsinki Principle 5 Workstream, Meg Nicolaysen (UK), and Fiona Stewart (World Bank).

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Introduction: Shifting to a Net Zero Mindset

Since the signing of the Paris Agreement in 2015, attention has increasingly shifted to the financial sector’s role in attaining the global climate goals. The transition to a carbon-neutral economy depends on all financial actors aligning their activities with the objectives of the Paris Agreement. To avoid locking in future emissions and to unlock climate financing, it is essential that investment and lending decisions in the private financial sector – including by banks, pension funds, insurers, and asset managers – take climate goals into account. This can also contribute to the financial stability of the system, facilitating an orderly transition to net zero emissions with minimal disruption to the economy. COP26 will appropriately, devote much needed time to the role of the financial sector in achieving these goals.

Financial institutions are joining a growing number of initiatives to align their lending and investment flows with the Paris Agreement goals. Individual institutions from all over the world are measuring climate impact, and have set climate alignment targets. National initiatives in European, Latin American, and Asian countries have been established to advance climate-aligned and sustainable finance. Internationally, institutions are collaborating under initiatives – such as the Net Zero Asset Owners Alliance, which aims to align portfolios with net zero outcomes in the real sector by 2050. The Glasgow Financial Alliance for Net Zero (GFANZ) is being launched ahead of COP26 to bring together net zero alliances in the financial sector, and to support them with frameworks to back up commitments with credible action. Nonetheless, implementation of such commitments remains challenging since compliance is not effectively controlled, nor real climate impacts accurately quantified.

However, important challenges exist regarding the definition of Paris alignment and establishing evidence of a financial institution’s climate impact on the real economy. First, a wide range of methods is being used to measure, report and define Paris alignment, and thus to operationalize different commitments. Second, an institution’s alignment process depends on its chosen method, and outcomes are not easily comparable across institutions. This leaves room for interpretation as well as potential ‘greenwashing’. Improving comparability and further harmonizing methods and metrics helps institutions to raise their ambition, providing clarity on where they should be heading, and enabling them to monitor progress and benchmark against each other. The same holds for real economy impact, as ‘portfolio alignment’ does not currently necessarily result in the reduction of emissions in the real economy.
Ministries of Finance (MoFs) and central banks, as well as international bodies such as the Coalition of Finance Ministers for Climate Action (‘the Coalition’), have a role to play in fostering robust climate alignment initiatives and methodologies. In this summary we focus on a number of different commitments and initiatives that have been undertaken. We take a closer look at the different tools and methodologies for achieving Paris alignment. Finally, we make a number of suggestions for potential action policy makers can take at the international and national levels.

Commitments to Achieving Paris Alignment

Financial institutions have increasingly been working towards Paris alignment through commitments and pledges, mostly through internationally convened networks. A 2020 study by researchers from the New Climate Institute and the University of Utrecht found that “financial institutions with cumulative assets of at least US$47 trillion under management are currently committed to climate-related investment targets.”¹ At the time, this assets under management represented around 25 percent of the global financial market.

A commitment is an important first step for a financial institution. Once the commitment has been made, the process of achieving Paris alignment may be broken down into five phases:

- Target-setting (where do I want to go?)
- Measurement (how do I measure progress?)
- Steering (how do I get there?)
- Tracking progress (where do I stand?)
- Reporting (how am I doing?)

A bank, pension fund, asset manager, or insurer ideally commits to all five phases in the Paris alignment process. In their legislative efforts, governments and supervisors are increasingly requiring institutions to engage in some or all of these phases. Ambitious commitments help financial institutions to meet these growing legislative demands. Engagement with such commitments from MoFs and the Coalition could be an important complement to legislative action. Recently, the Partnership for Carbon Accounting Financials (PCAF) has attempted to more clearly define the different phases of Paris alignment.²

Commitments on Paris alignment are a fundamental step towards decarbonizing balance sheets and portfolios, but operationalizing these commitments remains challenging. Analysis by the Financial Centers for Sustainability (FC4S) Network³ shows varying levels of ambition, and that only about a third of the 185 sustainable finance initiatives analyzed uses a climate tool or accountability methodology. This means that compliance might not be effectively controlled, and real climate impacts are not accurately quantified. Moreover, only a third of the sample includes concrete targets or requires compulsory reporting. The study also shows that accountability is

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¹ Katharina Lütkehörmöller, Silke Mooldijk, Mark Roelfsema, Niklas Höhne, Takeshi Kuramochi (2020). New Climate Institute. Unpacking the finance sector’s climate-related investment commitments.
³ A UN convened network of 35 international financial centers.
still limited, as transparency is not required under most of the commitments, with 80 percent of the initiatives not disclosing their associated institutions’ Assets under Management (AuM). The analysis also reveals that assessing real world impact is still challenging: although Globally Systemic Important Banks (G-SIBs) have increased their participation in sustainable finance initiatives at a remarkable rate, their fossil fuel finance (when considered as a group) has also increased since the Paris Agreement was signed, surpassing US$600 trillion as of 2020. To avoid greenwashing and inaccurate estimations of financial institutions’ committed capital, it is essential that commitments represent real ambition for financial institutions, and that these institutions have monitoring mechanisms in place to appropriately track progress.

The alignment of portfolios is no guarantee of real world impact: financial sector initiatives should be seen in a larger context. As the FirstRand case study shows (Box 2), alignment is hugely dependent on developments in the real economy. Furthermore, aligning a portfolio could mean selling off emissions to another institution, which would not actually take emissions out of the system. It is essential to recognize that activities that result in ‘relative’ rather than ‘absolute’ emissions reductions are insufficient in achieving long-term emissions reduction goals.

In several countries, efforts by the financial sector have been embedded in broader climate action. After all, MoFs have a central position within national financial sectors, and can play an important role in setting up collective national climate commitments, as demonstrated by the French and Dutch examples in Box 1. When the public sector is involved, accountability and comparability improve. Also, MoFs can ensure that linkages are being made between the financial sector and other governmental actors. This ensures that the financial sector’s experience with the transition can feed into the broader transition and policy-making process, improving the effectiveness of public policy. Similarly, international financial organizations can play a role in bringing together financial institutions, encouraging them to commit to Paris alignment in a meaningful way, promoting relevant tools and aligning with international standards.

**Case Study: Commitments in the Dutch and French Financial Sectors**

In July 2019 the Dutch government presented its national climate and energy plan (NCEP), which aims to reduce GHG emissions by 2030 to 49 percent of the level recorded in 1990. The plan includes a commitment by the financial sector, signed by over 50 institutions with combined assets of over €3 trillion. The institutions agreed to mandatory measurement and reporting of emissions from 2021 onwards. As of 2022, institutions will publish action plans that outline how they will contribute to a decrease in CO2 emissions, such as setting reduction targets. As part of the commitment, financial institutions will exchange knowledge and best practices on methodologies and actions that financial institutions can undertake to align their

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portfolios. As part of this effort, the financial sector aims to make climate methodologies more comparable to each other and to work towards further harmonization.

In a similar exercise in France, in July 2019 financial institutions in Paris (as part of the Paris financial center) committed to publish individual coal exit strategies. These commitments mean that by 2030 most French financial institutions will no longer finance coal in the EU and OECD countries, and from 2040 onwards in the rest of the world. These financial institutions will include their coal divestment strategies in their non-financial reporting. These pledges were made to the Minister of the Economy and Finance, demonstrating the importance of MoFs in monitoring these commitments. To ensure the credibility of these commitments, a compliance mechanism was set up by the French financial supervisors and the financial sector itself. The Sustainable Finance Observatory, launched in October 2020 by Finance for Tomorrow (a French sustainable finance association), together with professional federations, will ensure a high level of transparency. French financial supervisors are working to identify and measure the risks arising from climate change and to monitor and assess climate commitments.

Tools and Methodologies for Achieving Alignment

Moving from commitment to measurement is the second step for a financial institution. Different methodologies and tools contribute to the process of measuring and achieving Paris alignment of lending and investment portfolios, in support of the operationalization of the commitments and partnerships involved. Methodologies provide insight into the climate and emissions impacts of a financial institution’s loans and investments.

Different methodologies apply to the different phases of Paris alignment. Methods, such as the Platform for Carbon Accounting Financials (PCAF), contribute to the measurement phase, showing an absolute carbon output per asset. Other methods, such as the Science Based Targets Initiative (SBTi) Temperature Scoring methodology, portray indicators of the climate target in terms of a temperature score (where 1.5°C would be on track, while anything above 2°C would not). 2 Degrees Investing Initiative’s PACTA tool provides a sector-based approach, indicating how an investment or lending exposure aligns with different climate scenarios. Further detail is provided on key methodologies in the table below.
### Methodologies for measuring the Paris alignment phases

<table>
<thead>
<tr>
<th>EXAMPLE TOOL</th>
<th>PARTNERSHIP</th>
<th>SCIENCE-BASED</th>
<th>2DII PARIS ALIGNMENT</th>
<th>TRANSITION PATHWAY</th>
<th>POSEIDON PRINCIPLES</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>DESCRIPTION</strong></td>
<td>Partnership Carbon Accounting Financials (PCAF)</td>
<td>Science-Based Target for Financial Institutions (SBTi)</td>
<td>2DII Paris Alignment Capital Transition Tool (PACTA)</td>
<td>Transition Pathway Initiative (TPI)</td>
<td>Carbon Performance (Poseidon Principles)</td>
</tr>
<tr>
<td></td>
<td>Open and industry-led collaboration to measure and disclose GHG emissions of loans and investments</td>
<td>Scientifically-informed method for companies to set GHG reduction targets necessary to stay within a 2°C temperature rise above preindustrial levels</td>
<td>Open-source climate scenario analysis toolkit for investor and corporate lending portfolios to measure alignment with Internationale Energy Agency climate scenarios across key sectors and technologies</td>
<td>Carbon performance module that looks at how companies’ carbon performance now and in the future might compare to the international targets and national pledges made as part of the Paris Agreement</td>
<td>Framework for assessing and disclosing alignment of ship finance portfolios, by measuring carbon intensity on an annual basis and impact relative to established decarbonization trajectories</td>
</tr>
<tr>
<td><strong>SECTORS</strong></td>
<td>Cross-sectoral</td>
<td>Cross-sectoral</td>
<td>Power utilities, fossil fuels, automobile, cement, steel, shipping and aviation</td>
<td>Cross-sectoral</td>
<td>Shipping</td>
</tr>
<tr>
<td><strong>ASSET CLASSES</strong></td>
<td>Listed equity and bonds, business loans, CRE, mortgages, motor vehicle loans, project finance</td>
<td>Real estate, mortgages, electricity generation project finance, corporate debt and equity</td>
<td>Public equity, corporate bonds, corporate lending</td>
<td>Equities (to be expanded to fixed income)</td>
<td>Lenders, lessors, and financial guarantors with shipping portfolios</td>
</tr>
<tr>
<td><strong>METRICS/DATA</strong></td>
<td>GHG emissions</td>
<td>GHG emissions</td>
<td>Technology exposure (based on asset-level data) or GHG intensity (depending on sector)</td>
<td>Carbon intensity</td>
<td>Annual Efficiency Ratio based on fuel consumption</td>
</tr>
</tbody>
</table>
Each of the methods identified contributes to the operationalization of high-level commitments and the alignment of financial institutions’ portfolios. Currently, however, there is no single comprehensive methodology for determining alignment, or which captures all of the different phases. It is questionable whether there will ever be such a methodology, or even whether one is necessary. Each of the methods provides a starting point for assessing an institution’s progress towards Paris alignment, and could be used along with others, as they each have distinct objectives, strengths, and weaknesses, and also cover different sectors or asset classes. While a combination of methods could be useful, it is still necessary to work towards further harmonization, to increase comparability and accountability.

Case Study: A Method for Measuring Transition in South Africa

The transition to a low carbon economy poses serious challenges in South Africa, where over 90 percent of electricity is generated from fossil fuel activities and the coal industry is a significant employer. Transitioning to a low carbon economy needs to be measured with due consideration to a ‘just transition’. Emerging market financial institutions must balance the priorities of economic development, socio-economic inclusivity and equity, and climate-related impacts in the context of target setting and portfolio decarbonization.

PCAF is an open, collaboratively developed carbon accounting tool that is currently being used by financial institutions with combined assets worth more than US$15 trillion to measure and disclose the GHG emissions of various asset classes. FirstRand Limited, a South African Bank with about US$90 billion in assets, is testing the PCAF methodology for three asset classes: motor vehicle finance, commercial real estate, and mortgages. Challenges thus far in applying the emissions calculations methodologies result mainly from the limited availability of granular information on the portfolio. For example, in the motor vehicle finance asset class, no data was available on client-reported emissions, or even fuel use by vehicles. However, having identified where these gaps exist, data requirements and systems can be enhanced to improve data quality.

The FirstRand case shows that reliable and comparable climate data is still a challenge. Financial institutions depend on reporting by other firms, which is not always complete, fully developed, or available. Data on GHG emissions is limited as it often relies on diverse estimates or is self-reported. Insights developed using these methods should therefore be seen as only broadly indicative of where a financial institution stands, and where its climate impact is greatest. In addition, it is highly challenging to break down global or regional carbon budgets, targets, and scenarios to match data about individual investments. Future mandatory reporting standards could play an important role in improving data availability and comparability.

While there is no perfect methodology, work is ongoing to consider how best to advance this work. For example, the Portfolio Alignment Team, in collaboration with the COP26 Private Finance Hub, has identified a number of ways in which methodologies can be enhanced.\(^5\) This will require common and comparable metrics, which should


be forward-looking, allow comparisons to track progress over time, and incentivize transition. They should also provide broad coverage to ensure that a balance sheet is assessed in its entirety. Finally, the methodology should be transparent, and ‘feasible given data requirements.’ Our view is that the current absence of a coherent framework around those principles has resulted in a fragmentation of approaches and methodological differences that together inhibit meaningful comparison in the market. A recent TCFD consultation on forward-looking metrics revealed both the demand for such metrics in the financial community, and the challenges that need to be addressed for them to provide a useful input to financial decision making.

These challenges demonstrate, again, that MoFs have a potential role to play. MoFs could raise awareness and educate relevant actors in their financial sector on the different tools and methods that could help them to align their activities with Paris goals and national climate objectives. They could provide practical suggestions for financial institutions looking to start their Paris alignment journey, and make use of the available tools to assess the Paris alignment of their financial system. The TCFD consultation on forward-looking metrics is promising in that regard. Coalition members could also benefit from the work of the G20 Sustainable Finance Working Group, which will also consider how sustainability disclosure and reporting could be improved over time.

In developing the Paris alignment process, several issues need to be taken into consideration:

- Results of alignment methodologies need to be made more comparable and financial institutions need to be more accountable. Currently the figures released by different institutions are not easily compared, since data sources and methodologies may differ. Even for institutions that use similar tools or methods this might be challenging.
- The reliability and comparability of climate data internationally needs to be improved, as the FirstRand case confirms.
- The alignment of portfolios is no guarantee for real world impact. An important feature and test of alignment metrics will be how they support a whole economy transition that promotes engagement, and not only divestment.
- An effective Paris alignment approach considers different sectors and asset classes. A sector-based approach considers the fact that each sector has its own transition pathway or technology roadmap for alignment with the Paris goals. Different methods and metrics may thus be suitable for different sectors and asset classes.

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7 Data quality and availability have been mentioned by more than two thirds of FCAS financial centers as a key challenge to mainstreaming sustainable finance in 2020. Other international bodies highlighting this challenge are the IIF (2020), the G20 (2017, 2018), and WRI (2019), among others.
8 For example, an institutional investor could reduce the carbon intensity of its portfolio by selling a carbon-intensive asset such as an oil-refinery or cement plant to a buyer willing to continue operating the asset, thereby not actually reducing emissions.
9 For example, decarbonizing the shipping sector will rely on technologies other than those used to shift electricity generation away from coal-fired power plants. Certain sectors may require a specific methodology. The same holds for asset classes, which may need a bespoke approach: a corporate lending portfolio could require different tools or metrics than an investment portfolio.
Potential Actions for Ministries of Finance

The global financial system is still a long way from being aligned with the ultimate goals of the Paris Agreement, to achieve net zero emissions no later than the middle of the century and to achieve adaptation targets in countries globally. Key challenges which hinder financial institutions’ effectiveness at meeting these goals include the varying definitions of Paris alignment and considerations of real world impact. Significant work must still be done to improve the design and accountability of initiatives and commitments, to enhance current tools and metrics, and to harmonize commitments and methodologies.

MoFs are well placed to foster alignment within their respective financial sectors. They could achieve this by:

- Raising awareness and educating financial sector actors on the different tools and methods for aligning their activities with Paris goals and national climate objectives.
- Actively facilitating system-wide sustainability and climate initiatives and commitments within their jurisdiction. For instance, they could encourage system-wide Paris alignment or set up Paris alignment assessments.
- Bringing different industry associations together, setting up knowledge sharing and monitoring mechanisms, and public-private dialogues that feed into the policy-making cycle.
- Collaborating with the private sector at the level of financial centers to stimulate the development of an enabling policy environment, allow the definition of a high-level strategy, and foster the necessary skills in financial industry professionals.

Case Study: Monitoring Financial Sector Climate Action in Switzerland

The Swiss federal government periodically monitors the impact of financial institutions’ voluntary climate action. In 2020 all Swiss financial market actors were invited to test their portfolios for their compatibility with the goal to limit the global temperature increase to 1.5° C, voluntarily, anonymously, and free of charge. The results showed that there is still a long way to go to achieve full alignment of the financial sector with this Paris goal, but positive developments were visible.

A country-wide test allows for comparison between peers, different types of financial institutions, and different products. It triggers knowledge exchange on effective action and facilitates the sharing of best practices. All participants receive an individual test report, which includes their results on climate alignment as well as a comparison with benchmarks and their peers. The financial institution chooses whether – and what findings – to publish. The report serves as input for political and public debate, and the findings can trigger exchanges between financial institutions and stakeholders, as well as financial institutions and relevant authorities.
The Coalition could play a role in encouraging Paris alignment in the financial sector within its member states. Specific suggestions include:

- Supporting TCFD in its work on forward-looking metrics to address the challenges and secure the benefits that alignment metrics can bring, to support the transition to net zero.
- Facilitating the exchange of knowledge between members setting up financial system-wide or collective commitments, and assessing Paris alignment in the financial sector. The Coalition could build capacity for the assessment of Paris alignment in country-level financial sectors.
- Working to expand knowledge and best practice sharing on climate alignment initiatives, methodologies, and metrics. We recommend that the Coalition initiate follow-up work to explore how to the further harmonize different methodologies, establish common principles for the Paris alignment methodologies, and translate these effectively into clear alignment indicators.
- Engaging with the COP26 team, to ensure the Coalition’s work is aligned, and to consider this work could be leveraged in the light of COP26. Continue to engage with the G20 SFWG to ensure there is alignment between the two bodies and to take advantage of synergies between the work of each.

These measures could further incentivize financial institutions to green their balance sheets, address transition-related risks, and could be an important amplifier of broader climate policy.