Recommendations on Leadership Practice

Working Group 1: Net Zero Finance & Disclosure of Climate Risks

April 15, 2022

Executive summary on relevant template questions

3. How should Race to Zero encourage leadership on this issue (the stretch goals which members should aim for)? Where do we see inspiring examples of leadership? What guidance can it provide to Partners for driving upward convergence?

We recommend Race to Zero (R2Z) firstly clarify the role of leadership practice within the R2Z framework. In our view, the easiest way to do this is to have (1) starting line criteria (which applies to all members) and then (2) leadership practice as a "step up" going beyond mandated activities (and can have specific industry focuses). All recommendations below are in addition to meeting starting line criteria. Anything in [brackets] refers to areas of diverging viewpoints.

On existing leadership practices, we recommend:

- Scope 3 for financial institutions means including portfolio/ loanbook/insured/ facilitated emissions, which is comprised of the investee companies and/or clients' emissions, including the Scope 3 of the underlying investee companies and/or clients [where they are material] to total emissions and where data availability allows them to be measured sufficiently.
- Equity considerations should prioritise goals to meet the divide between developed and developing countries.
- Empowerment considerations should prioritise a just transition.
    - Just transitioning planning should be included within an actor's transition plan.

We recommend introducing a distinct financial institution leadership practice. Financial institutions exhibiting leadership should:

Set absolute emissions reduction targets

Set sector-specific targets

- Set sector-specific targets which include a carbon/ unit of productivity metric (e.g., TCo2e/ tonne of steel) in accordance with specific sector budget that correspond to a total economy wide carbon budget
- Set sector-specific climate solutions financing targets (i.e. % Capex invested in sustainable hull design for shipping sector or % Capex into renewable infrastructure for oil and gas sector)
- Ensure residual emissions are calculated and uniquely neutralised at the sector level to encourage financing of best in class real economy companies.
- Set absolute emissions reduction targets

Invest in global equity demands

- Ensure capital flows for climate solutions to meet the needs of developing countries, especially in adaptation and mitigation finance.

Invest in essential climate solutions and adopt innovative financial tools

- Recognise and explore essential climate solutions where investment is needed most e.g., energy efficiency and renewables. Tools such as Race to Zero's net zero financing roadmaps may be useful.
- Adopt innovative financial tools (particularly blended finance) that mature essential low carbon sectors e.g., energy efficiency and renewables. This could involve collaboration with public, concessional and impact finance.
- Publish capital commitments where available

Align company engagement, proxy voting, and policy engagement with the financial institution's net zero targets and transition plan.

- Set expectations that all portfolio companies and fund managers -must immediately commit to net zero emissions across their value chains by 2050 and in line with 50% absolute emission reductions by 2030.
- Explicitly state and implement escalation pathways that may include co-filing shareholder resolutions, voting against management or the Board, not purchasing new bond issuance, and/or [divestment] if agreement with the investee company is not reached within 18 months of engagement.
- Adopt and implement proxy voting policies that align with the 2030, other interim and 2050 targets of Race to Zero. Publicly pre-declare voting intentions on climate resolutions and director votes with the intention of accelerating the 1.5C aligned transition.
- Align management and executive remuneration with both interim and net zero targets.
- Create or participate in coalitions that have the specific purpose of lobbying in support of the goal of restricting global temperature rise to 1.5C above pre-industrial levels.

Invest in natural capital

- Include the objective to meet a nature positive target, entailing directly supporting investment in nature and ensuring a portion of transition investments positively contribute to nature.
- Transitioning pledges should invest in projects that support the resilience of natural systems.

(Note: deforestation free portfolios are recommended as minimum criteria, if not possible to implement as minimum, the working group suggests this as a leadership criteria)

Enable the respect for Indigenous rights

- Financial institutions should establish robust due diligence and verification mechanisms to ensure clients fully respect and observe all human rights, including the right to Free, Prior and Informed Consent) as articulated by the UN Declaration on the Rights of Indigenous Peoples.

We recommend introducing a distinct financial institution leadership practice for R2Z partners. Financial R2Z partners exhibiting leadership should:

Encourage absolute targets

- Aggregating partnership level absolute emissions data for reporting to Race to Zero
- Clearly identifying To Race to Zero where absolute emissions targets are set and where sector-specific targets are set.

4. How could Race to Zero and its Partners expect these strengthened and enhanced criteria to be operationalised by members? Expectations should include indications of timeline, metrics for reporting etc.

We recommend R2Z provide relevant resources to partner organisations on climate topics, depending on what organisation is considered to have the most expertise. Throughout, we provide links to leading methodology and resources.

Although it was not a focus, the working group has also considered disclosure leadership practice. Before crafting a R2Z leadership practice, we recommend R2Z follow existing best practice guidance in the area of disclosure e.g. TCFD and future work of IFRS.

Please see our detailed analysis below for further recommendations on disclosure, including on and in relation to:

- Financial statements
- Climate stewardship
- Climate lobbying
- Climate risks
- [Materiality]
- Investment reporting

Other comments

It is worth mentioning two final recommendations from our working group

- Clarifying fair share: we recommend R2Z clarify this as either common but differentiated responsibilities between countries, or between/ within sectors.
- Onboarding philanthropic organisations: we recommend an R2Z strategy to onboard philanthropy. Grant finance is critical and currently less than 2% of philanthropy is directed toward the climate. Potential philanthropic R2Z partners include WINGS and those involved in the #PhilanthropyForClimate pledge.

Specific recommendations shaded in light purple (“Alternative Views”) indicate that no clear consensus view was identified.

Detailed recommendations and alternative views are as follows

3 & 4. Leadership practices

Recommendation	Rationale
Leadership practice in general	
Clarify the role of leadership practice in the Race to Zero (R2Z) framework	The difference between starting line criteria and leadership practice is unclear. The current guidance states initiatives must satisfy both but then there are “must” and “may” distinctions (required and optional, respectively). R2Z should have (1) starting line criteria and then (2) leadership practice as an optional “step-up” to go beyond mandated activities. The aim should be to make what leadership is today a normal expectation tomorrow, and use leadership to continuously ratchet up expectations and accelerate the transition.
Recognise leadership among R2Z leaders	R2Z should find a way to praise and recognise leadership in order to encourage its uptake either at partnership level or individual member level. This could be done through monthly press coverage, videos, or publications celebrating successes and leadership. *See operationalisation recommendations.*
Provide relevant resources and guidance	R2Z should provide more external resources to R2Z partners, depending on what organisation is considered to have the most expertise (we provide some links below). This will add to the benefits of signing up and being part of the R2Z network. Overall, we also recommend that further guidance be provided within the interpretation guide.
Existing leadership practice	
Scope 3 Include a financial leadership practice on **Scope 3** and consider other leadership suggestions ***Alternative Views***	• Resources: The working group recommends R2Z link partners to sector best practice/ tools in identifying Scope 3 emissions e.g. PCAF methodology or equivalent. • Outstanding versus committed: The PCAF methodology to calculate financed emissions requires use of outstanding funds to attribute client emissions. There may be some benefit in using “committed funds” instead. This needs to be weighed against risks of overestimating size exposure. • Exposure default metric | ISSB: Banks should consider an exposure default metric. Another member recommends that R2Z align with the boundary definition of ISSB, as this is likely to be the coming global standard (Note: ISSB disclosure will not have been finalized when this R2Z revision is introduced so indicating there is an intention to introduce this but not define it until ISSB

	disclosure framework is finalized.). In that way, we will ensure that emissions-data from Scopes 1 & 2 can be made comparable with financial data like revenue, produced quantities and cash flow. ● There was a suggestion that the emissions Scope 3 emissions could be categorized into on-balance or off-balance sheet activities and suggest the EPRG to look into the feasibility of this.
Offsets - Adopt a similar approach to SBTi (starting line) and consider other leadership suggestions	*See starting line criteria recommendations, where a similar approach to SBTi is recommended: no use of offsets in meeting interim targets and then only removals for residual emissions..* Scepticism towards offsets is shown by the fact that many offsets are not additional and do not represent reductions. Members applauded the existing wording in the R2Z criteria: "Encourage immediate contributions to the preservation and restoration of natural sinks, not necessarily linked to neutralization claims." ***Other suggestions*** To build on leadership practice, there were a few suggestions from our working group: ● Absolute best practice should be abatement, but R2Z should allow for compensation and neutralisation on that journey. (Leadership practice could reflect IIF's "high-ambition path to net-zero".) ● Focus should be on minimising the removable emissions and residual emissions, not on how to offset them. ● If offset interpretation guidance is included, there is an opportunity to clarify in which sectors it is justifiable (e.g., hard to abate in the interim) and which it is not. It may also be worth outlining the difference between using an offset (and the risks involved in low quality offsets) vs. fully decarbonising. ● Restorative activities: should be encouraged. Is there a way of indicating contribution to technologies/ nature based solutions that help to reduce emissions, rather than netting down? ● Investee aid: We should encourage the financial sector to drive maximal outcomes with their investees (mitigating first), without putting the onus on the financial industry itself. ● Shadow prices: Businesses setting their own shadow prices could help show others the reality of emitting carbon and incentivise more investment into emissions reduction (see this LSE UK guide). ● Canada's Climate-Aligned Finance Act [Bill S-243] has a good section on offsets that could be adapted.
Explicitly recognise the need to meet demands	**Developing country finance** The leadership practice is silent to the Global North | Global South divide. The current

of **developing countries** Explicitly recognise **just transition**	interpretation guide only states that *"equity can refer to, inter alia, the division of GHG emissions across between or within countries at different stages of development".* The working group recommends that goals to meet the divide between developing and developed countries should be more explicitly addressed in R2Z leadership practice. Suggestion that there are domestically focused actors who should be balanced in this mission. **Just transition** The working group recommends that empowerment considerations should prioritise a just transition. A leadership practice may encourage: *"consideration of just transitions within all transition plans".* (Note: some members of the group felt this should be starting line criteria). R2Z partners should draw from guidance from UN ILO and emerging practice coming from CA100+, Principles for Responsible Investment (PRI), the World Benchmarking Alliance and London School of Economics. The working group applaud the reference to the UN SDGs within the current interpretation guide, which help with just transition frameworks.
Net zero finance leadership practice	
Include sector-specific emissions reduction and climate solutions	**Financial sector** In addition to meeting starting line criteria, financial institutions may exhibit leadership by: ● Setting sector-specific targets which include a carbon/unit of productivity metric (i.e. Tco2e/tonne of steel) in accordance with specific sector budget that correspond to a total economy-wide carbon budget. ● Setting sector-specific climate solutions financing targets (i.e. % CAPEX invested in sustainable hull design for shipping sector or % CAPEX into renewable infrastructure for oil and gas sector) ● Ensuring residual emissions are calculated and uniquely neutralised at the sectoral level to encourage financing of best in class real economy companies.
Set absolute emissions reduction targets through requirements for financial sector partners	● Set absolute emissions reductions targets **Financial sector partners** In addition to meeting minimum criteria, financial partner initiatives of Race to Zero may exhibit leadership on absolute emissions by: ● Aggregating partnership level absolute emissions data for reporting to Race to Zero ● Clearly identifying To Race to Zero where absolute emissions targets are set and where sector-specific targets are set.

Adopt a leadership practice on **developing country finance**	**Further leadership practice:** ● Ensure capital flows for climate solutions to meet the needs of developing countries, especially in adaptation and mitigation finance. The working group recommends that goals to meet the financial divide between developing and developed countries should be more explicitly outlined. R2Z should be a champion for efforts toward the 100B climate finance commitment, and beyond. There was however also a suggestion on balancing the needs of domestically focused R2Z actors.
Explore climate solutions in areas where investment is needed Expand Race to Zero's *net zero financing roadmaps* initiative.	**Further leadership practice:** ● Recognise and explore climate solutions where investment is needed most e.g., energy efficiency and renewables. Tools such as Race to Zero's net zero financing roadmaps may be useful. The working group noted that *what* needs to be financed is a huge area where a lot of further thinking could be done and promoted. At the Net Zero Finance Conference 2022, it was noted that a lot of investment is going into transport solutions, whereas energy efficiency is not gaining much attention. There was also a suggestion that investment strategies are highly linked with government policy and that any encouragement between non-state actors to governments in releasing such strategies is useful. In terms of operationalisation, we commend Race to Zero's work on net zero financing roadmaps. We recommend a dedicated team is supported to continue this excellent work, and give R2Z partners a steer on where investment is needed most. Perhaps it could be a tool that is only privately available to R2Z members, to incentivise wider membership.
Adopt innovative financial tools and public capital commitments	**Further leadership practice:** ● Adopt innovative financial tools (particularly blended finance) that mature essential low carbon sectors e.g., energy efficiency and renewables. This could involve collaboration with public, concessional and impact finance. ● Publish capital commitments where available Blended finance tends to be a de-risking tool where financial institutions can work with governments to operationalise net zero strategies. Deploying sections of a financial institution's books in a concessionary fashion is another innovative financial tool. Financial institutions should be working alongside governments to explore pipelining longer-term investment opportunities.

	Some helpful tools to consider on this front include CPI's *Blended Finance in Clean Energy report* which found that the greatest opportunities for blended finance impact are in Sub-Saharan Africa and South and East Asia, with a subset of eight high impact countries alone offering USD 360B in clean energy investment potential by 2030. It could be helpful to specify a threshold for members to demonstrate innovation e.g., publishing capital commitments where financial institutions have them and encouraging action where they do not.
Adopt and implement ambitious climate stewardship activities	For investors conducting stewardship activities: ● Set expectations that all portfolio companies and fund managers must immediately commit to net zero emissions across their value chains by 2050 and in line with 50% absolute emission reductions by 2030. ● Explicitly state and implement escalation pathways that include co-filing shareholder resolutions, voting against management or the Board, not purchasing new bond issuance, and/or [divestment] if agreement with the investee company is not reached within 18 months of engagement. ● Set expectations that all portfolio companies align management and executive remuneration, capital expenditure, and climate accounting with both interim and net zero targets. ● Adopt and implement proxy voting policies that align with the 2030, other interim and 2050 targets of the Race to Zero commitment. ● [Publicly pre-declarare voting intentions on climate resolutions and director votes with the intention of accelerating the 1.5C aligned transition] ● Support climate resolutions on a 'comply or explain' basis [and vote consistently on climate-related proposals across geographies] ● Participate in collaborative engagement including sector/value chain engagement in addition to direct/indirect corporate engagement. *Diverging viewpoints on divestment as an escalation pathway* Escalation strategies were seen by members as an important tool to engage investees that are not responding with sufficient urgency. The main area of divergence was on whether to include divestment as an escalation pathway. On the one hand, quite a few members expressed that this is a useful tool of "last resort" and can be used effectively as a tactic to get companies to move. Others felt that bigger threats lay elsewhere e.g., replacing Board members and that divestment options risk worse options, where there is less transparency and oversight from a public investor standpoint.

<table>
<tr><td></td><td>Further leadership practice (partner initiatives)
Be transparent and report publicly the lead engager(s) engagement milestones and progress being made.</td></tr>
<tr><td>Practice policy engagement/ lobbying that accelerates climate action</td><td>Further leadership practice (financial institutions)
In addition to starting line public policy engagement…
Create or participate in coalitions that have the specific purpose of lobbying in support of the goal of restricting global temperature rise to 1.5C above pre-industrial levels
The above suggestion is based on the recently released Global Standard on Climate Lobbying, which is supported by PRI, Ceres, among other investor network organizations. Alignment of policy engagement with company commitments stems from a concern that actors are pursuing contradictory claims e.g. commodity traders making commitments to stop deforestation, then opposing policies in line with deforestation.</td></tr>
<tr><td>Align all financial services with net zero pledge</td><td>Further leadership (financial institutions):
Set expectations that all portfolio companies and/or clients - particularly those in carbon intensive sectors including coal, oil and gas, utilities, auto manufacturers, airlines, other transportation industries, construction, real estate, infrastructure and steel - must immediately commit to net zero emissions across their value chains by 2050 and in line with 50% absolute emission reductions by 2030.</td></tr>
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Include the objective to meet a nature positive target, entailing directly supporting investment in nature and ensuring a portion of transition investments positively contribute to nature.
Transitioning pledges should invest in projects that support the resilience of natural systems.</td></tr>
<tr><td>Adopt policy to address Indigenous rights</td><td>Financial institutions should establish robust due diligence and verification mechanisms to ensure clients fully respect and observe all human rights, including the right to Free, Prior and Informed Consent) as articulated by the UN Declaration on the Rights of Indigenous Peoples.</td></tr>
<tr><td>Explore shadow pricing and penalising factors</td><td>The working group noted that this was more of a regulatory issue, and not an issue for RtZ to advance, however, it was worth noting that there was a suggestion that big financial institutions should set their own shadow pricing requirements. Moreover, R2Z may wish to consider supporting a brown penalising factor/ green supporting factor/ amendment to capital risk requirements. Changing capital risk requirements from the current range of 4-8% (depending on the asset) to a higher percentage for high-carbon investments has the potential to incentivise financial institutions to pivot large</td></tr>
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	quantities.
Disclosure leadership practice	
General comments	The working group did not spend a lot of time discussing disclosure leadership practice. We are conscious that a number of organisations are creating best practice around disclosure, and we recommend R2Z follow their guidance e.g., the existing work of TCFD and CDSB, and future work of IFRS to bring all standards together into one standard, which is being consulted on this year. Nevertheless, some specific areas for potential leadership practice on disclosure are outlined below:
Financial statement disclosure	Financial institutions should: ● Consider material climate-related matters and disclose the consideration of as well as the financial impact on their own financial reporting (e.g. in estimating expected credit losses on receivables/loans) in the notes to the audited financial statements. ● Discuss the effects of material climate-related matters with their financial statement auditors. ● Discuss their own investors' climate-related needs in financial reporting ● Assess and engage on climate accounting and audit disclosures of investee companies: e.g. see CA100+ Benchmark Climate Accounting and Audit Alignment Assessment to be released March 2022) ● Engage with market regulators and standard -setters on these issues and respond to all relevant consultations to improve the reporting of material climate-related matters: e.g. see SEC proposal (March 2022).
Climate stewardship disclosure	● Publicly pre-declare voting intentions on climate resolutions and director votes with the intention of accelerating the 1.5C aligned transition ● Disclose all voting records and rationale within three months of the annual general meeting date regardless of how votes are cast ● Ensure that voting records are aligned with voting policies and explain any divergences
Climate lobbying disclosure	● Publicly disclose overall assessment of the influence that climate lobbying has had on (a) supporting ambitious public climate change policy; (b) the company's ability to deliver its own corporate transition strategy.
Climate risks	● Outline not only how the company intends to manage climate risks, but consider the company's positive and negative contributions to climate risks and outline how it intends to manage its impact

Double materiality ***Alternative Views***	• Incorporate a double materiality lens A diverging view on double materiality was that companies still need to figure out materiality for investors in financial reporting and already worry about the costs of increased sustainability disclosures. There were also views that companies should eventually move towards reporting based on double materiality as the predominant approach when there is a global climate disclosure standard.
Remuneration	• Disclose sufficient detail about remuneration policies for investors to understand how management and executives will be assessed against relevant climate-targets • Disclose, in detail, how remuneration policies are aligned with climate-related targets. Or, if not yet aligned, explain why. • Provide a detailed breakdown of total current and prior year executive remuneration expense, in ccy or %, to the different policy metrics.
Investment reporting	There was a suggestion that R2Z could consider requesting a report on investment in emissions reduction (both CAPEX investments + beyond value chain). However, the difficulties with current reporting practice and the extra burden this would place on actors was considered to be more concerning. EU reporting on “green CAPEX” has also led to some problems.
Other	
Clarify fair share as either common but differentiated responsibilities between countries, or between/ within sectors	The starting line criteria currently requires “maximum effort toward or beyond a fair share”. While this encourages action beyond fair share, it also creates confusion and may need to be clarified: perhaps “beyond” fair share is a leadership practice? More importantly, what is meant by fair share is unclear and should be clarified in the interpretation guide. Is this a nod to the global equity approach (common but differentiated responsibilities) or does it mean fair share between sectors? If it is the latter, R2Z needs to be clear on what these fair shares might be. Our working group advocates for a common approach, rather than letting entities decide.
Encourage grant finance and **onboard philanthropic organisations**	**There needs to be a R2Z strategy to onboard philanthropy.** Currently, less than 2% of philanthropic funds is focused on climate change mitigation (Climateworks Global Intelligence). Grant finance is critical to catalyse innovative solutions and global equity climate projects.

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<td>Potential R2Z partners include:
#PhilanthropyForClimate pledge (hosted by WINGS):: https://philanthropyforclimate.org/. (Note country pledges like Canada’s go into detail for leadership practice for funders at three different levels: getting started, building momentum or demonstrating leadership).
The Global Climate Action Summit pledge (representing 39 philanthropies). These philanthropies have pledged to invest at least $6B by 2025 and are on track to exceed commitments.
Other features of a strategy could include a potential leadership practice:
Allocate more than 5% of resources to projects directly aligned with the net zero transition</td>
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