



Climate compatible investing – How is it done?

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Climate alignment is one of the most important challenges for investors. However, in order to achieve a climate impact, there are a number of things to consider. In this article, we highlight important considerations for data that supports investors in their goal of achieving climate alignment.

Climate compatible investing – How is it done?

Last June, the Swiss Federal Council introduced the Swiss Climate Scores. These comprise a series of indicators on the climate alignment of investments financial institutions are recommended to disclose. But what does climate alignment mean in the context of investments? Which indicators are actually suitable for effectively supporting climate-friendly investing?

Climate-compatible or financial flows are aligned to support and drive the economy towards achieving the Paris climate goals. At the core of these goals is limiting global warming to 1.5°C. This in turn requires a rapid and comprehensive reduction of greenhouse gas (GHG) emissions as well as net zero GHG emissions by 2050 at the latest.

In order to make their investments climate-friendly, investors select their investments in a targeted manner and use their ownership rights (active ownership). The overarching goal is to rapidly drive structural change towards net zero. To this end, for example, the share of investments in activities that already have almost net-zero emissions, such as renewable energies, should be rapidly expanded. This is particularly effective because renewable energies replace activities with high emissions - fossil fuels. Active ownership activities are suitable for bringing about change in companies that have higher GHG emissions but cannot currently be replaced. These examples show that investments in different economic activities with different emission profiles also require very different and tailored data.

What climate data is currently available?

Exposure to the fossil fuel sector:

This indicator shows the share of investment in the fossil fuel sector. It thus indicates activities that should be divested as quickly as possible from a climate perspective, because net zero alternatives already exist. Beyond this information, the usefulness of the indicator is limited, as the focus is only on part of the value chain. Activities that ultimately use fossil fuels, such as automobiles or chemistry, are not shown.

GHG Intensity and Footprint:

The intensity indicator relates the GHG emissions of invested companies to their turnover or to production units, the footprint to the invested capital. GHG intensities and footprints are well suited to compare the current climate impact of economic activities that provide the same type of service. An example is the comparison of different activities with the energy or the transport sector, which both feature a wide range of alternatives. In any case, the mandatory prerequisite is that Scope 1 to 3 emissions are fully covered.

However, these indicators are only suitable to a limited extent for comparisons between different types of services, as these often cannot be provided with the same level of emissions, e.g. construction materials vs. software.

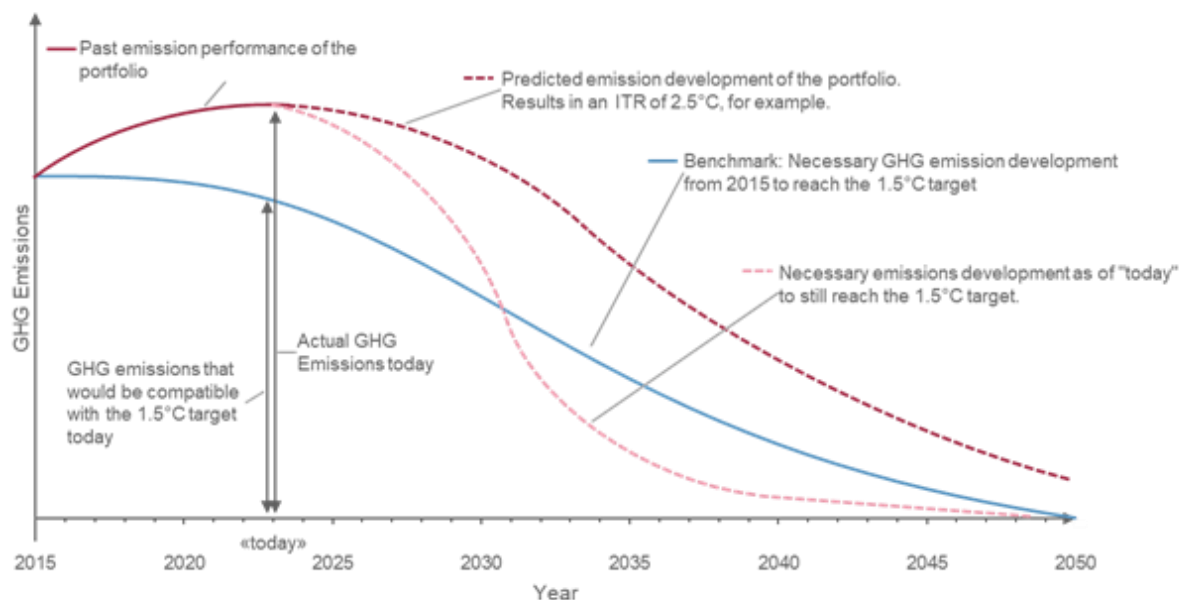
Implied Temperature Rise Metrics:

So-called implied temperature rise (ITR) metrics assign emission budgets or specific reduction pathways derived from climate scenarios to different sectors or economic activities. The budgets or pathways serve as benchmarks and are compared with the expected future emissions of companies. The result of ITR metrics is a temperature (e.g. 2.5°C). This temperature indicates how much the earth would warm up if all companies complied with their allocated emission budgets as well or as poorly as the company under consideration.

ITR metrics in principle allow the comparison of completely different activities. However, they are particularly well suited to assessing activities with relatively high GHG emissions. This is especially true if the activities provide a service that satisfies an important societal need and no low-GHG alternative exists yet, e.g. steel or cement.

Figure 1: Climate alignment of a portfolio.

All key figures at portfolio level are made up of the sum of the individual investments. GHG intensities and footprints show the climate impact at a given point in time. Exposure to fossil fuels would represent a part of these emissions. ITR metrics assess the development of the portfolio companies in comparison to the allocated emissions budget or reduction path (the benchmark). This benchmark specifies the necessary development of the portfolio to be compatible with the 1.5°C target, for example.



The main disadvantage of ITR metrics is that by their very nature they can only assess companies' targets and plans, but not the extent to which these will actually be achieved. Furthermore, both the emission budgets and the future emissions of the assessed companies are based on a large number of assumptions over a long period of time. Therefore, the data is currently still unreliable and contradictory between different providers. In order to at least reduce uncertainty, it is important to include the most recent and robust data possible (including past GHG intensity trends) for the predictions. Regardless of this, ITR metrics are not useful for activities that should be completely divested anyway (e.g. fossil energies), as the future emission development does not really play a role here.

Conclusion:

In order to invest in a climate-friendly way, different indicators have to be combined depending on the invested economic activities. Present data is useful to compare economic activities that meet the same needs. ITR metrics are particularly useful to compare activities that have high GHG emissions and cannot be replaced.

Inrate can help investors invest effectively in a climate-friendly way through a wide range of data, active ownership services and proven expertise. Our data solutions include ESG Impact Ratings, GHG intensities and footprints (scope 1, 2 and 3), exposure to the fossil fuel sector and a wide range of other ESG-related data.