# Carbon Emissions: Known unknowns

Maarten Vleeschhouwer

Alignment tools don't yet confirm if emissions reductions in the real economy have genuinely taken place, nor whether we have contributed to them, says **Maarten Vleeschhouwer**, Head of PACTA at 2° Investing Initiative.

**Maarten Vleeschhouwer** is Head of PACTA at 2° Investing Initiative (2DII), an independent, non-governmental organisation (NGO) working to align financial markets and regulations with the Paris Agreement goals. He also served the European Commission as seconded national expert to assist in the implementation of the Action Plan on Financing Sustainable Growth. In particular, he contributed to the Technical Expert Group on Sustainable Finance, focusing on building an EU taxonomy, an EU Green Bond Standard, low-carbon benchmarks, and metrics for climate related disclosures. Prior to that, Vleeschhouwer worked on sustainable finance at the Dutch National Bank, where he also authored the bank's report on climate-related risks in the Dutch financial sector. Maarten holds an MA in International Relations and International Economics from the Johns Hopkins University School of Advanced International Studies.

**In October 2020, HSBC, among a number of other financial firms, announced it would reach net-zero financed emissions by 2050, yet it also admitted that climate-related data is provided by only 12% of its loan portfolio. It seems as though there is no consistency in the reporting, data and methodologies needed to determine whether or not an investor is net zero, Paris-aligned, and so on. Why is assessing the emissions associated with a portfolio so fiendishly complex and why is there no consistency to measurement?**

Aristotle said, 'The more you know, the more you realize you don't know'. And when working on integrating climate considerations and finance, that saying rings very true. As you start doing it, you learn. You figure out what works and what does not gradually. Especially when it comes to Paris alignment, the reason why we don't have consistency is because we have only solved for parts of the puzzle.

If you think about alignment in its most basic form, it is about the proper positioning of one element, or one part, with another element or part. So, in this case, it's about the proper positioning of your investments with the Paris Agreement – the latter being a future state of the world. And that's obviously where it's going to get complex, because how do we know what the world looks like in the future? We know we're going to be net zero, but what does that mean in practice?

Some sectors will need to move much faster than others. And in some sectors low-carbon breakthrough technologies already exist – power – and in others they do not yet – like steel, cement, and aviation. The transition and capex plans of companies are also more available in some sectors than in others. So, as you start to unpack alignment and look at how to measure that in practice, you realise what you know and what you don't know. And there is still quite a lot we don't know.

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**In your analysis of the Swiss financial sector[1], you found that, overall, the sector is not aligned with the Paris Agreement. The study concludes that alignment tools "do not (yet) tell you whether emissions reductions in the real economy have actually taken place, and whether you as a financial institution have contributed to those reductions". Can you elaborate on these findings?**

Swiss investors decreased their exposure to coal power between 2017 and 2020, which made them more aligned with the Paris Agreement – although not yet fully. But if you look at the cause for that decline in coal power exposure, it is actually mostly the result of divestment and not because companies became greener. The portfolio is more aligned, but there are not less real-world emissions. So, we should keep in mind that we don't necessarily know where emissions go when they're no longer in your portfolio. And we shouldn't assume that, just because they're out of your portfolio, the emissions stopped happening.

Our methodology, the Paris Agreement Capital Transition Assessment (PACTA), predominately looks at the technology shift that's needed across certain sectors to slow global warming and then measures this against the actual technology that a bank's clients are using – or plan on using in the future. This methodology is being used by around 60 banks worldwide, but it only works for a few sectors. One of the banks using it is ING. And if you look at ING's Terra reports, you will see that they're quite open about their struggle to integrate climate considerations into different asset classes. While they will use PACTA for various economic sectors, they use different approaches for different asset classes or sectors not covered by PACTA, which is very sensible because there are no one-size-fits-all solutions.

But there are plenty of other finance institutions that are just looking for a quick fix, or an acronym to join, so they can say to the politicians, or to the activists or NGOs, that they're doing 'something'. And they tend to oversell what they're doing or what they're working on.

### When people talk about 'impact' they often mean different things. Given recent examples, such as DekaBank being sued for allegedly misleading retail investors over the social and environmental impacts of one of its funds, would you agree that much of what passes for impact investment today is really labelling of things that would be done anyway? Moreover, to what extent can the financial sector actively contribute to decarbonising the economy?

It is crucial to differentiate between 'investor impact' and 'company impact'. Investor impact is the change it induced on the investee company through the investing and lending activities. Capital providers have several opportunities to generate a positive impact in the real economy through their investing and lending activities. They can enable 'green' companies to grow faster, encourage 'brown' firms to improve their sustainability performances, influence other investors in their investment decision-making processes, and influence regulators through political lobbying. But simply investing in an already green company does not ensure that the investor has had a positive impact. The investor needs evidence that his investment has made a difference.

> "Measuring the real impact of actual investments is most probably impossible as it implies a counterfactual scenario – what would have happened if the investment had not been made – that cannot be known"

The problem is that 'additionality' is quite hard to prove. Measuring the real impact of actual investments is most probably impossible as it implies a counterfactual scenario that cannot be known – that is, what would have happened if the investment had not been made. Instead of searching for clear evidence for investment impact, we consider that research can, on the one hand, identify impact mechanisms at the investment level through empirical studies and, on the other, gather evidence for outcomes at the investee level. If we simultaneously observe that an investment involves classic impact mechanisms and that the investee displays a clear improvement in its sustainability performance, we conclude that is probable – although not certain – that the investment had a positive impact.

At 2DII, we are currently working on assembling those pieces of the impact puzzle. Unfortunately, there is thus far little academic research testing whether companies that use the most common 'green' financial products decarbonize their activities faster than non-users. If the financial sector wants to effectively contribute to the decarbonization of the economy, it should propose products that meet certain conditions: transferring the green project risk to the funders; serving undersupplied markets – like households or SMEs; providing flexible capital – at concessional terms or with customized features – for green projects; and including in the product specifications mechanisms to constrain the issuer to align with science-based targets.

### How hopeful are you that regulators will force more rigour in our ability to measure, compare and align portfolio temperature – and will this ultimately provide any more clarity around the climate impact of banks hitting their emissions targets, for example?

As a former supervisor, I'm probably a bit biased. I'm very hopeful. Through PACTA, we work a lot with supervisors. And supervisors are always interested in how things work. What does the data really tell you? What does it actually do? Is it meaningful? How? Supervisors are always trying to get to the bottom of what a metric can do and what are its limitations. That's a big strength – and it's something that is clearly needed in sustainable finance. Not all green washing is on purpose – sometimes it is simply a lack of understanding of the current limits of integrating sustainability in finance.

Of course, you're going to need to have a strong story to convince supervisors about why what you're doing makes sense – certainly from a climate risk management perspective. But I do think that regulators, and for sure supervisors, will bring more rigor. Supervisors are not beholden to anyone or anything and will cut through marketing stories. This may take time – remember, it's also a new topic for supervisors. And, to apply Aristotle again, just because you understand finance doesn't mean you understand sustainability considerations. But supervisors undoubtedly have a role to play in separating the wheat from the chaff.

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[1] *Source: 'Bridging the gap: Measuring the progress on the climate goal alignment and climate actions of swiss financial institutions', 2 Degrees Investing Initiative, November 2020: https://2degrees-investing.org/wp-content/uploads/2020/11/Bridging-the-Gap.pdf*

## ESSENTIAL THINKING

**REPORT**

Waterproof? An exploration of climate-related risks for the Dutch financial sector https://www.unepfi.org/psi/wp-content/uploads/2018/08/Waterproof_An-exploration-of-climate-related-risks-for-the-Dutch-financial-sector.pdf

Bridging the gap: Measuring the progress on the climate goal alignment and climate actions of swiss financial institutions https://2degrees-investing.org/wp-content/uploads/2020/11/Bridging-the-Gap.pdf

**ARTICLE**

Where do carbon emissions go when they're no longer in your portfolio? https://www.responsible-investor.com/articles/where-do-carbon-emissions-go-when-they-re-no-longer-in-your-portfolio

**COMMENTARY**

How to unlock the banking sector's potential to address climate change https://www.reutersevents.com/sustainability/how-unlock-banking-sectors-potential-address-climate-change

*About this interview*

*At Natixis Investment Managers, we often seek outside perspectives to gain true diversity of thought. Our interpretation of environmental, social and governance (ESG) is informed through collaboration – with organisations like the PRI, but also with industry experts and academics from outside asset management. To that end, this interview is part of our series of insights that seek to find more nuanced perspectives on sustainable investing and to cut through the noise in ESG. We're taking a closer a look at how ideas like blended finance, policy influence and shareholder engagement are becoming key instruments in enabling investors to have a meaningful impact. So we've interviewed those individuals who we consider leading thinkers in this area in a bid to explore a better way forward in ESG.*

*Maarten Vleeschhouwer is not affiliated with Natixis Investment Managers and is independently responsible for the information, expressed views and opinions he provided in this article.*

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