LSEG Transition Finance Case Study

EXCERPT FROM GFANZ'S CASE STUDIES ON TRANSITION FINANCE AND DECARBONISATION CONTRIBUTION METHODOLOGIES

LSEG is one of the world's leading providers of financial markets infrastructure and delivers financial data, analytics, news and index products to more than 40,000 customers in over 170 countries.

LSEG has set out a variety of goals for its products and services using the Net Zero Financial Service Providers Alliance (NZFSPA) framework as a basis. These goals cover LSEG's role as a data and analytics provider, as an exchange, and as an index provider.

In relation to this case study, it is worth noting that LSEG, through FTSE Russell, has set targets to grow the range of climate transition indexes it provides to the market including the FTSE TPI Climate Transition Index Series. LSEG is also an active member within the GFANZ Index Investing workstream to help identify opportunities and hurdles associated with the construction and maintenance of Net Zero indices.

LSEG'S APPROACH TO TRANSITION FINANCE

LSEG is a leading global financial infrastructure and data provider, playing a vital social and economic role in the world's financial system. LSEG provides a wide range of services to meet customer demand to enable the financial industry and community to integrate climate and net zero considerations into financial decision-making and capital raising. FTSE Russell, an LSEG business, helps investors integrate climate and climate transition priorities into index design through a combination of headline climate index families and custom indexes.

There are different approaches to measuring and judging both corporate and sovereign climate performance. LSEG curates and partners with others, such as the Transition Pathway Initiative, to offer access to a wide variety of climate data and metrics. Metrics are provided as data products by LSEG's Data and Analytics division and are also the building blocks for index solutions. The data products cover areas including corporate climate emissions; climate governance; level of involvement in climate solution products; climate targets data; as well as more sector-specific data such as for fossil fuels extraction. These data packages are used by active investors to inform portfolio construction and corporate engagement as well as index design and construction.

There are a variety of different indexes available to meet the variety of different types of investor demand present in the market. Typically, index design starts with an existing FTSE Russell benchmark and then varies the weights of constituent companies or sovereigns by applying different climate parameters; if a constituent performs well, this leads to a relative over-weight and if it performs poorly, then a relative underweight. Another approach is to instead include or exclude companies based on climate data. FTSE Russell's flexible model can support all types of client investment priorities — from decarbonizing investment portfolios in line with the Paris Agreement, while maintaining diversified market exposure, to investing specifically in clean tech solution providers, or using climate alongside traditional risk-premia "smart-beta" approaches to align with investment beliefs.

In addition to forming the basis of investment portfolios, indices that capture elements of the climate transition (e.g., issuer decarbonization targets, green revenues) are used by some investors to underpin their stewardship activities by aligning their investments to corporate climate practices and performance. The transparent index methodology helps reinforce corporate engagement and stewardship, as both investors and investee firms have clarity on how they can meet index inclusion rules or increase their index weighting.

The FTSE TPI Climate Transition Index Series is a family of equity indices that capture company-level assessments by the Transition Pathway Initiative (TPI) and improve exposure to carbon and green revenues. Established in 2016, the TPI is led by asset owners and supported by asset managers with FTSE Russell acting as a data partner since initiation. The TPI's mission is to assess the world's biggest companies from high-emitting sectors on their transition to a low-carbon economy. These assessments are made available publicly on the TPI website. In 2022, the TPI's ambitions were significantly expanded with the establishment of the TPI Centre at the Grantham Research Institute on Climate Change and the Environment at London School of Economics.

The core company assessments TPI publishes are Management Quality (MQ) and Carbon Performance (CP). These forward-looking assessments evaluate a company's climate governance and management of climate risks and opportunities (MQ scores), and the strength of a company's targets/commitments to decarbonize based on sector-specific pathways (CP assessments).

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The FTSE TPI Climate Transition Index Series integrates MQ and CP assessments directly into its index design, providing investors with a benchmark that reflects company alignment with the climate transition. The TPI index series also adjusts exposure to carbon emissions and reserves and green revenues and applies baseline exclusions.

The first index under the FTSE TPI Climate Transition Index Series was launched in 2020 in collaboration with the Church of England Pensions Board (CofE). A key feature of this index is that a revenue share from investor usage helps fund the TPI academic research at the London School of Economics.

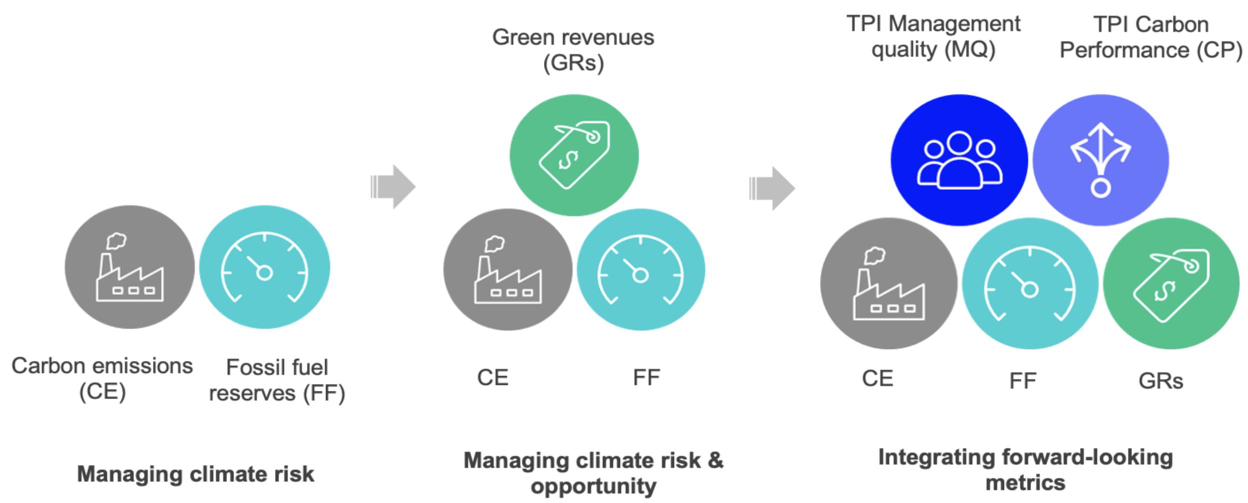
The five different LSEG Climate Assessment Metrics are applied in the index, which are used to overweight and under-weight constituent companies. The weightings of these can also be customized to meet specific client needs and investment beliefs. General alignment with GFANZ transition framework is given in the rightmost column (Figure 1).

Figure 1. Climate transition metrics in the FTSE TPI Climate Transition Index Series

Transition metrics	Description	GFANZ Category
TPI Management Quality	Over or underweight companies according to their management quality ("climate governance")	Aligned / Aligning
TPI Carbon Performance	Over or underweight companies according to their carbon performance ("Below 2DC/1.5DC pathways")	Aligned / Aligning
Carbon emissions	Over or underweight companies according to their operational GHG emissions revenue intensity	Aligned / Aligning
Green Revenues	Overweight companies contributing to the transition to a green economy	Climate Solutions
Fossil fuel reserves	Underweight companies with majority ownership of proved and probable fossil fuel reserves	Managed Phase-out

Source: FTSE Russell.

Figure 2. Three stages of integrating transition risk in investment indices



Source: FTSE Russell.

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Since 2010 the types of climate indexes that FTSE Russell has designed have continued to evolve from an initial simple approach (managing climate risk, using 2 of the metrics), to the full integration of forward-looking metrics in the FTSE TPI Climate Transition Index Series.

The FTSE TPI Climate Transition Index Series incorporates GFANZ's Aligned/Aligning and Climate Solutions financing strategies using the following climate data inputs:

Aligned/Aligning:

- Traditional carbon exposure metrics (i.e., over-or-underweighting based on operational carbon intensity relative to business peers) are used in constructing the FTSE TPI Climate Transition Index Series. However, alignment with net zero trajectories is primarily assessed through the two evaluation frameworks: (1) TPI Management Quality and (2) TPI Carbon Performance, which together are intended to provide a holistic view of companies' progress in the climate transition. Together, the TPI evaluation frameworks cover all key themes of the GFANZ Net Zero Transition Plan (NZTP) framework: Foundation, Governance, Implementation Strategy, Engagement Strategy, and Metrics and Targets.
- Ultimately, the TPI MQ assessment focuses on processes common to all companies, while the TPI CP assessment focuses on sector-specific decarbonization ambition and commitment.

TPI Management Quality (MQ) Score

- The TPI MQ score evaluates and tracks the quality of companies' governance and management of their greenhouse gas emissions and of risks and opportunities related to the climate carbon transition.
- TPI MQ indicators are relevant to all companies in the investable universe, allowing investors to compare across sectors and to focus engagement on common KPIs and climate disclosures.
- Companies tend to implement their carbon management systems and alignment plans in stages. As enumerated in the GFANZ NZTP framework, companies often start by acknowledging their ambition, publicly acknowledging the relevance of climate change to their business and developing high-level policies (Attribute A), before moving on to setting increasingly stringent and quantitative targets (Attribute B).
- Accordingly, TPI's MQ framework tracks the progress of companies through the following five levels: unaware; awareness; building capacity; integrating into operational decision making; and strategic assessment.[1]
- This enables companies with stronger climate governance to be over-weighted in the index.

TPI Carbon Performance (CP) Score

- TPI CP score evaluates carbon emissions and target ambition of companies in high-emitting sectors against climate scenarios consistent with the UN Paris Agreement, corresponding to the Performance attribute of the GFANZ NZTP framework (Attribute E). It does this by comparing both current and projected carbon intensities of a company's products against sector peers and against sector-specific benchmarks.
- This approach reflects the fact that different sectors (e.g., oil and gas production; electricity generation; and automobile manufacturing) face different challenges arising from the climate transition, including where emissions are concentrated in the value chain and how costly it is to reduce emissions.
- TPI's CP assessment is based on the Sectoral Decarbonization Approach (SDA). The SDA translates greenhouse gas emissions scenarios into appropriate sector benchmarks against which the performance of individual companies can be compared. Companies are assessed as being in one of five CP categories; (i) 1.5 degrees C aligned; (ii) Below 2 degrees C; (iii) National pledges; (iv) Not aligned; and (v) No disclosure.[2]
- This enables companies with robust climate targets to be over-weighted in the index.

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[1] For a full description of the methodology see: TPI. TPI's methodology report: management Quality and Carbon Performance. Nov. 2021.

[2] Information about CP methodologies for each sector are available on the TPI website.

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Climate Solutions/Enablers:

Climate Solutions/enablers are an area where LSEG uses a unique and separate set of data based on the FTSE Russell Green Revenues Data Model, which provides investors with a highly granular and flexible dataset for corporate revenue exposure to the green economy based on detailed categorisation of revenues across 133 green microsectors. Green Revenues' data can also be used to identify qualifying revenues based on the EU Sustainable Finance Taxonomy.

Green Revenues Data Model

- The model focuses on revenues from products and services that provide environmental solutions including climate mitigation and adaptation.
- Green Revenues percentage is either calculated from detailed company disclosure (when sufficient revenues data is provided),or estimated based on non-revenue company or sector data, if a company does not provide a suitable sub-segmental revenue breakdown.
- This allows companies with greater levels of green revenue to be over-weighted in the index.

Managed Phaseout:

The Managed Phaseout category is one where the fit between the GFANZ category and the index methodology is not exact but where there is some overlap. Note that the carbon reserves data described here is also used alongside the TPI MQ and TPI CP metrics described earlier when assessing high carbon companies.

Fossil Fuels Data Model

- This assessment aims to understand the total level of GHG emissions that are represented by a company's total coal, oil and gas reserves and is normalized by the total market capitalization of the company.
- This means that if a company has a high level of reserves relative to its market cap it is more heavily underweighted and is weighted in the index more highly if the total reserves are more negligible relative to market capitalization.

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RECEPTION AND EVOLUTION OF LSEG'S APPROACH TO TRANSITION FINANCE

The FTSE TPI Climate Transition Index Series — and other climate index families that also use TPI data — have seen broad adoption since they were launched in 2020. Among the clients that have demonstrated significant adoption of the indices are the Church of England, Brunel Pension Fund, Phoenix Group, and the New York State Common Retirement Fund. The FTSE Russell initiative has garnered recognition within the sustainable finance ecosystem, including awards from UN PRI and Environmental Finance for innovative climate index products.

Investors are attracted to the FTSE TPI Climate Transition Index Series as a method to align their portfolios to the climate transition for various reasons, including:

- The transparent methodology and public data inputs of TPI assessment frameworks allow investors to tailor their engagement to target specific KPIs and areas of improvement for their investee firms (from risk management procedures to emissions exposure and reduction targets).
- The use of multiple metrics in a "dashboard approach" reduces the reliance on any one KPI or indicator and further adds flexibility to investor engagement strategy.
- Frameworks are used where they are most applicable; for instance, for companies in high emitting sectors, the TPI Carbon Performance assessments deliver granular assessments using comparable sector-specific KPIs, evaluating company targets against climate scenarios.

While the overall FTSE TPI Climate Transition Index Series has remained consistent, the individual building blocks continue to evolve in sophistication:

- TPI indicators continue to change with the latest climate scenarios and corporate disclosures. For example, the Management Quality score has added a new level to further distinguish companies that disclose concrete details on the specific aspects of their transition plans (Transition Planning and Implementation).
- Other climate datasets, such as Carbon Emissions and Green Revenues, will continue to develop as disclosure rates improve and regulations align across regulatory jurisdictions.

Lessons Learned

- The FTSE TPI Climate Transition Index Series captures the philosophy of the Transition Pathway Initiative by recognizing that many investors wish to retain broad market exposure while increasing or decreasing exposure to companies that are either aligned or not aligned to key elements of the climate transition. In particular, the indices cater to growing investor demand for more sophisticated implementation approaches to climate change.
- The index approach enables improvement of key climate transition KPIs while maintaining broad equity exposure without divestment from key sectors. The indices also fulfill existing investor requirements for sustainable investment portfolios, with significantly lowering carbon emissions and fossil fuel reserves exposures relative to market benchmarks.
- The TPI Climate Transition Index Series offers key support to investor engagement with their portfolio companies. Through the index, pension funds can directly link improvement of a company's TPI assessment and transition commitments with increased investment flows. TPI's analysis is also a central component of the CA100+ assessment, further strengthening the detail, level, and alignment of investor engagement.
- As frameworks for both assessing alignment and identifying solution providers rely on public disclosures, it is important that index methodologies and underlying data sets make use of increasingly available and granular disclosures. Disclosures detailing transition plans and carbon reduction targets, capital spending in line with the EU taxonomy, and others as documented in the GFANZ Aligned and Aligning Attributes will all be helpful to further enhance the data, analytics, and index solutions available for investors.
- Through the partnership of FTSE Russell with the Transition Pathway Initiative, the FTSE TPI Climate Transition Index Series continues to evolve, enabling investors to apply the latest TPI analysis directly into index design.

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