Market consultation

FTSE Russell

FTSE Russell Client Consultation: Enhancing Climate Change scores in ESG Ratings and FTSE4Good Indexes

FTSE Russell client consultation: Planned enhancements to the assessment of climate change management in ESG Ratings and FTSE4Good indexes

Summary

Investor focus on climate risk has grown significantly in recent years. In response to this, FTSE Russell has developed a number of data and index tools to better measure and manage these risks. As part of these efforts, FTSE Russell is also reviewing the way climate change is addressed as part of its ESG Ratings.

Through this consultation, clients and other stakeholders are invited to provide feedback on proposed enhancements to the climate change assessment of corporate issuers in ESG Ratings with implications for a number of indexes that rely on these Ratings and related enhancements to the FTSE4Good index rules. These can be summarised as follows:

Proposal 1: Enhancing the Climate Change theme score within ESG Ratings.

Proposal 2: Introducing minimum Climate Change score thresholds to the FTSE4Good Index Series inclusion rules.

Key Rationale

- The enhancements to the calculation of Climate Change theme scores will more accurately capture corporate performance on climate change.
- Investors globally are placing a greater focus on climate risk and transition and the proposed changes deepen the way this theme is represented in the ESG Ratings and associated indexes.
- They involve no new indicators, lower the reporting burden for corporates, whilst more closely aligning and underpinning key global investor climate initiatives.
- Previously the methodology has been enhanced to align with Task Force on Climate Related Disclosures (TCFD) and the current proposed refinements achieve further alignment with the TCFD and the Transition Pathway Initiative.
- Introducing minimum Climate Change score thresholds within FTSE4Good will raise corporate standards on these issues and ensure that companies in carbon intense sectors can only maintain membership if they take climate risks seriously.

Proposed timelines:

The proposed changes would be effective from the December 2020 index review:

- Companies would be informed of changes in July 2020; giving them approximately 18 months' notice to meet criteria to maintain FTSE4Good membership.
- Enhanced Climate Change scores are first incorporated within ESG Ratings from December 2020.
- New FTSE4Good inclusion rules applied to companies from their next review, with 12 months to improve if criteria are not met.

Responding to the Consultation

Please submit your response to the questions included in this consultation online at https://www.surveymonkey.co.uk/r/PL5MVYZ

All responses will be treated as confidential. FTSE Russell may publish a summary of the consultation results, but no individual responses will be published and no respondents will be named.

Proposal 1: Enhancing the Climate Change theme score within ESG Ratings

FTSE Russell proposes two key enhancements to the calculation of the Climate Change theme score – one of 14 themes within the ESG Rating.[1]

1. The enhanced Climate Change theme will focus on 16 core indicators drawn from the existing theme. These 16 indicators mirror key disclosures recommended by the Task Force on Climate Related Disclosures (TCFD) in the form of tangible data and targets.[2] Please see Appendix 1 for more details on these indicators.

2. Companies will be assessed on a "staircase", requiring specific indicators to be met to achieve each subsequent level. Scores will be between 0 (worst) and 5 (best). For example, emissions disclosures and targets must be disclosed for a company to move beyond Level 3. Please see Appendix 2 for the requirements that must be met at each level.

Impacts

The proposed enhancements will drive modest decreases in both average Climate Change theme scores and ESG Ratings.

There is a strong correlation (0.86) between existing Climate Change theme scores and those based on the enhanced methodology outlined above. However, the enhanced methodology sets a somewhat higher bar for corporates, resulting in lower Climate Change theme scores (0.89 lower on average) and a smaller reduction in average overall ESG Ratings (0.11 lower on average).[3]

Question 1: Do you support the proposed enhancements to the Climate Change theme of FTSE Russell's ESG Ratings model?

a) Yes, fully
b) Yes, with amendments (please comment below)
c) No (please comment below)
d) Other (please comment below)

Please enter your comments here:

[1] These enhancements are the result of two years of intensive collaboration between FTSE Russell and the Grantham Institute of the London School of Economics in the context of the Transition Pathway Initiative. Adoption of the proposed enhancements would align the Climate Change theme with the Transition Pathway Initiative's Management Quality (MQ) score, which itself uses data inputs from FTSE Russell's Climate Change theme to assess companies' readiness for transition to a low carbon economy. Note that Level 5 in the enhanced theme will correspond to a 4* score in TPI's MQ methodology.

The Transition Pathway Initiative (TPI) is a global initiative led by asset owners and supported by asset managers. Aimed at investors and free to use, it assesses companies' preparedness for the transition to a low-carbon economy, supporting efforts to address climate change. Launched in 2017, it is rapidly becoming the "go-to" corporate climate action benchmark and aligns with the recommendations of the Task Force on Climate-related Financials Disclosure (TCFD). For further information, please visit the Transition Pathway Initiative's website: https://www.transitionpathwayinitiative.org/

[2] Recommendations of the Task Force on Climate-related Financial Disclosures

[3] Based on FTSE All World Index constituents as at 24/06/2019, with scores representing 99.32% of index weight.

Proposal 2: Introducing minimum Climate Change score thresholds to the FTSE4Good Index Series inclusion rules

Proposed enhancements to FTSE4Good Index series inclusion rules:

The proposed changes to inclusion rules would raise corporate standards for the management of Climate Change issues within the FTSE4Good Index Series and related indexes, including FTSE Blossom Japan Index, FTSE4Good TIP Taiwan ESG Index, FTSE4Good Bursa Malaysia Index and FTSE/JSE Responsible Investment Index Series.[4] Through the introduction of minimum thresholds based on the Climate Change theme score, companies will be required to make specific, salient climate disclosures to be constituents of these indexes.

The proposed thresholds (Figure 1) are tailored to industry (high emitting or other industries) and market (developed or emerging) types, reflecting the differing levels of climate risk that each face. "High emitting" industries are defined as those in four ICB Industries: Oil & Gas, Basic Materials, Industrials, and Utilities.[5] Companies operating in high emitting sectors can only maintain their membership if they take climate risks seriously, disclose their emissions and are setting reduction targets.

Figure 1. Proposed minimum Climate Change score threshold for index inclusion[8]

	FTSE4Good Developed & related indexes[6]	FTSE4Good Emerging & related indexes[7]
High emitting industries	Score of 3 required	
All other industries	Score of 2 required	Score of 1 required

Impacts

The "worst-case" impact of this proposal (and Proposal 1) on FTSE4Good index membership if it was implemented immediately without the grace period can be seen in Figure 2**.** The actual impact on index turnover is expected to be significantly lower due to ongoing improvements in climate disclosures and the effect of corporate engagement in improving company scores.

Figure 2. Maximum potential impact of proposed enhancements on index membership[9]

	FTSE4Good		FTSE Blossom	
	Number	**Weight**	**Number**	**Weight**
Companies currently in Engagement (2020 thresholds)	81	4.1%	10	1.6%
Added to engagement with enhanced Climate Change theme score integrated within ESG Ratings (*Proposal 1)*	+77	+3.0%	+9	+1.9%
Companies added to engagement with minimum Climate Change score thresholds *(Proposal 2)*	+248	+5.4%	+12	+5.8%

[4] Proposed changes would not be applied to the FTSE4Good US Select Index
[5] https://www.ftserussell.com/data/industry-classification-benchmark-icb
[6] Includes FTSE Blossom Japan Index
[7] Includes FTSE4Good TIP Taiwan ESG Index, FTSE4Good Bursa Malaysia Index and FTSE/JSE Responsible Investment Index Series
[8] Note that we expect standards to align between developed and emerging markets over time
[9] Based on data as at 24/06/2019 with December 2020 inclusion thresholds applied

Question 2: Do you support the introduction of Climate Change minimum theme score thresholds to the FTSE4Good Index Series inclusion rules?

a) Yes, fully
b) Yes, with amendments (please comment below)
c) No (please comment below)
d) Other (please comment below)

Please enter your comments here:

Proposed timelines

The proposed changes would be effective from the December 2020 index review:

- Companies would be informed of changes in July 2020; giving them approximately 18 months' notice to meet criteria to maintain FTSE4Good membership.
- Enhanced Climate Change scores are first incorporated within ESG Ratings from December 2020.
- New FTSE4Good inclusion rules applied to companies from their next review, with 12 months to improve if criteria are not met.

Figure 3. Proposed timeline for implementation

July 2020	December 2020	June 2021	December 2021	June 2022
Consultation and announcement	**Implementation at the index review**	**June 2021 Index review**	**December 2021 index review**	**June 2022 index review**
Consultation with stakeholders finalised. Changes publicly announced. Companies informed of the changes and the timelines involved.	Companies updated for the December 2020 index review will receive new ESG Ratings calculated using the enhanced Climate Change scores. Constituents below new minimum thresholds will be required to improve by December 2021.	Companies updated for the June 2021 index review will receive new ESG Ratings calculated using the enhanced Climate Change scores. Constituents below new minimum thresholds will be required to improve by June 2022.	Engagement companies from the December 2020 review will be deleted if they have not moved to meet the minimum thresholds.	Engagement companies from the June 2021 review will be deleted if they have not moved to meet the minimum thresholds.

Question 3: Do you support the timelines for implementation proposed?

a) Yes, fully
b) Yes, with amendments (please comment below)
c) No (please comment below)
d) Other (please comment below)

Please enter your comments here:

Additional comments

Do you have additional comments on the proposals?

Please enter your comments here:

Appendix

Appendix 1: Indicators in enhanced Climate Change theme

Indicator legend	Indicator type	Indicator description
ECC01	Qualitative	Climate Change impact including CO2 /GHG emissions – Policy or commitment statement to: **a.** Address the issue **b.** Reduce or avoid the impact or improve efficiency
ECC43	Qualitative	Recognition of climate change: **a.** As a relevant risk and/or opportunity to the business **b.** Discloses time horizon (short/medium/long term) of risk/opportunity
ECC03	Qualitative	Demonstrating support for mitigating climate change through: **a.** Membership of business associations **b.** Company position on public policy and regulation
ECC38	Qualitative	Short term (up to 5 years) quantitative targets to reduce GHG emissions (which could include scope 1 and/or scope 2 and/or scope 3): **a.** Unquantified, process targets **b.** Quantified targets* *Details of quantified targets will be recorded.
ECC39	Qualitative	Long term (more than 5 years) quantitative targets to reduce GHG emissions (which could include scope 1 and/or scope 2 and/or scope 3): **a.** Unquantified, process targets **b.** Quantified targets* *Details of quantified targets will be recorded.
ECC08	Qualitative	Board oversight of climate change: **a.** Evidence of board or board committee oversight of the management of climate change risks **b.** Named position responsible at Board Level
ECC41	Qualitative	Independent verification of operational GHG emissions data: **a.** Independent verification by third party **b.** International assurance standard used and level of assurance declared
ECC14	Quantitative	Three years of total operational GHG emissions data (Scope 1 & 2) is disclosed

Indicator legend	Indicator type	Indicator description
ECC44	Qualitative	Impact of climate-related risks and opportunities. The company: **a.** Details how they incorporate climate change risks and opportunities in their strategy (mitigation, new products, R&D, etc.) **b.** Discloses the impact of climate change risks and opportunities on financial planning (OPEX, CAPEX, M&A, debt)
ECC45	Qualitative	Climate scenario planning: **a.** The company mentions the 2 degree scenario in relation to business planning, or confirms it has conducted climate related scenario analysis **b.** The company describes the business impact of one or more climate scenario analysis
ECC49	Quantitative	Scope 3 emissions (3 years) split by category
ECC50	Qualitative	Climate-related risk management procedures: **a.** Integrated into multi-disciplinary company-wide risk management **b.** Specific climate-related risk management process
ECC51	Qualitative	Internal carbon price: **a.** Company has an internal price of carbon **b.** Company discloses the price of carbon
ECC73	Qualitative	The company discloses: **a.** Its memberships of trade associations that engage on climate-related issues. **b.** Its involvement in these trade associations.
ECC74	Qualitative	The company has a stated policy or commitment to ensuring: **a.** Consistency between its climate change policy and the positions taken by the trade associations of which they are members. **b.** For responding appropriately in those instances where the trade association position is significantly weaker than or contradicts that of the company.
ECC75	Qualitative	Does the company's remuneration for senior executives incorporate climate change performance? **a.** CEO **b.** At least one other senior executive.

Appendix 2: Indicators required at each level of the enhanced Climate Change theme

LEVEL 1
Requires any of:

ECC01	Commitment to address climate impact
ECC43	Recognition of climate as a relevant risk
ECC38	Short term GHG emissions reduction targets
ECC39	Long term GHG emissions reduction targets
ECC14	Operational GHG emissions data (Sc 1 & 2)

OR two of:

ECC50	Climate risk management procedures
ECC75	Climate-related remuneration arrangements
ECC44	Climate included in strategy, fin. planning
ECC45	Climate scenario planning, findings disclosed
ECC51	Internal carbon price adopted and disclosed
ECC74	Consistency of trade association positions

LEVEL 2
Requires:

ECC01	Commitment to address climate impact

AND either

ECC43	Recognition of climate as a relevant risk

OR two of:

ECC50	Climate risk management procedures
ECC75	Climate-related remuneration arrangements
ECC44	Climate included in strategy, fin. planning
ECC45	Climate scenario planning, findings disclosed
ECC51	Internal carbon price adopted and disclosed
ECC74	Consistency of trade association positions
ECC39	Long term GHG emissions reduction targets

LEVEL 3
Requires:

Level 2 to be met

AND

ECC14	Operational GHG emissions data (Sc 1 & 2)

AND either

ECC38	Short term GHG emissions reduction targets

OR

ECC39	Long term GHG emissions reduction targets

LEVEL 4
Requires:

Level 3 to be met:

AND all of:

ECC08	Board oversight of climate change
ECC49	Scope 3 GHG emissions*
ECC41	Independent verification of emissions data
ECC03	Trade associations and public policy position
ECC73	Involved in corporate initiatives on climate
ECC50	Climate risk management procedures

LEVEL 5
Requires:

ALL 16 INDICATORS TO BE MET

*Companies in the following ICB Subsectors must disclose Scope 3 Use of Sold Product Emissions: Automobiles, Coal, Commercial Vehicles & Trucks, Exploration & Production, General Mining, Integrated Oil & Gas, Pipelines.

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