CLIMATE-FOCUSED PAI INDICATORS

Required changes for accurate transparency and just transition

Although the Sustainable Finance Disclosure Regulation (SFDR) applies to Financial Market Participants (FMPs) active in the EU **internal market**, SFDR disclosures have **global consequences**. Investors in and outside the EU base their decisions on data published according to the SFDR. At the same time, a regulation whose objective is to focus capital flows toward sustainable objectives must account for the needs of all markets. It must not undermine flows to markets where the range and depth of sustainability-based needs is greatest – developing economies.

Currently, the existing climate focused principal adverse impact (PAI) indicators are acceptable and useful for comparing investees based in developed economies. Though there are differences between countries, there is an acceptable like-for-like basis for comparison. However, these indicators are not appropriate for analysing small- and medium-sized enterprises (SMEs), smallholders, micro-businesses and other investees in emerging economies. For instance, smallholder farms in Tanzania are not a driving cause of climate change and have not contributed to the historical emissions incurred. They are already operating and living at emission levels which all the developed world only expects to reach in 2030. This is not due to advanced technology but simply because they lack the levels of consumption and prosperity that lead to high emissions in most developed countries. For a **just transition it is essential that those SMEs have a fair chance to prosper in a sustainable manner**. Reporting on adverse impact must reflect this adequately.

Climate-focused PAI indicators do not provide the full picture of an investee's impact on climate. This information gap is threatening a just transition, as envisaged in the EU Green Deal and the Paris Agreement. Moreover, this information gap has the potential to **shift capital flows away from emerging economies where millions of people are most in need of sustainable development**. This shift in investor behaviour is already being felt in Europe, undermining the stated development targets of the EU and many member states, to catalyse sustainable investment in the developing world.

Problem

Climate-focused PAI indicators are misleading

PAI indicators 2 (carbon footprint: emissions per invested million) and 3 (GHG intensity of investee companies: emissions per revenue) do not accurately disclose negative effects of investment decisions on sustainability. A brief summary of how this occurs:

- The different levels of capital intensity between companies in developed countries and (in particular) small companies in emerging economies leads to systematically incorrect outputs via the "carbon footprint".
- Small companies in emerging economies do not have any possibility to report their footprint directly. Sector-based estimations - which is the current practice – repeatedly overestimate the intensities.
- Small companies in emerging markets have limited opportunity to reduce their emissions as either the required financing is not available or the technological choice is not available.

In practice, if investors lack contextual information (e.g. production-based and consumption-based emissions per capita, see explanatory article) to assess how the two PAI indicators should be considered when investing in emerging economies, current SFDR reporting standards might mislead investors. This information gap goes against the **SFDR objectives of market transparency and investor protection**.

responsAbility Investments AG
Zollstrasse 17
8005 Zurich
Switzerland
Phone +41 44 403 05 00
www.responsAbility.com
info@responsAbility.com

Background

Just transition as an objective under the EU Green Deal and the Paris Agreement

The need for better quality data is also required to **ensure a just transition as envisaged under the EU Green Deal and the Paris Agreement**.

- Omitting information on country GHG emissions per capita (ideally consumption-based) can influence investors to divest or move away from investees in emerging economies. For instance, when smallholder farmers (who often live on less than 2t GHG emissions per capita) receive investment and develop, their absolute emissions increase. However, the total increased emissions are still extremely low when compared to that of investees in developed economies and/or consumers served by investees in developed countries. The current PAI indicators do not reveal this context.
- Disincentivizing investments in these SMEs and other investees in emerging economies can significantly impair progress toward the SDGs. For instance, without these investments, millions of people would be kept in poverty, with worse quality of life outcomes and reduced climate resilience. SMEs in emerging economies already have very scarce access to finance. In addition to existing barriers, misleading disclosures can accentuate this scarcity.
- The EU Commission and the EU Parliament have repeatedly recognized the EU's commitment to the **Agenda 2030, the EU Green Deal, and the Paris Agreement**. Action is necessary to implement these commitments.

Proposed solution

Enhanced disclosure of climate-focused PAI indicators

In light of the above, we would like to propose:

a) Maintaining the existing PAI indicators 2, and 3, despite their limitations.

b) Including an additional PAI indicator which simply states the consumption based per capita emissions of the country in which the investee company operates (at portfolio level this would of course be calculated on a weighted average basis).

Though this solution is far from being perfect, it will still allow investors to understand that while the reported footprint or intensity of their portfolio may increase or be at a higher level, their investments are directly or indirectly reaching **people who live at emission levels which are fully in line with a sustainable pathway and the goals of the Paris Agreement**.

This paper is a very concise summary of complex climate-related matters (smallholder farmers are used as an example to represent various types of small businesses struggling in emerging economies). responsAbility works to enable the development of these businesses and benefit the people reached by them. We would be happy to participate in more detailed discussions.