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Subject: Review of CalPERS' Climate Solutions Accounting Framework

Following CalPERS' 2023 announcement of its 2050 Net Zero Plan, which includes a strategy to allocate a cumulative $100 billion towards "Climate Solutions" investments by 2030, CalPERS engaged Mercer to review its proposed Climate Solutions Accounting Framework in September 2024. The scope of work for this engagement consisted of the following:

1. Identify, compile, and describe regulatory frameworks or guidelines issued by reputable industry bodies that could assist CalPERS in determining if a fund can be classified as a "climate solution". The compiled frameworks and associated criteria will be evaluated for relevance to CalPERS' climate solution taxonomy.

2. Conduct two Climate Solution classification eligibility tests using the criteria compiled in the first deliverable. The first test will be performed on the CalPERS Climate Transition Index. The second test will be conducted on a private markets fund selected by the CalPERS SI team.

3. Review CalPERS' climate solutions bottom-up eligibility rules for each asset class and benchmark them against best practices. Provide an analysis (Knowledge Transfer) of how these rules compare to industry standards.

4. Review and provide an opinion on CalPERS' Climate Solutions Accounting Framework, with a focus on potential greenwashing risks.

In order to complete these deliverables, Mercer conducted a robust landscape scan of relevant frameworks and guidelines globally to identify key findings to share with CalPERS, and engaged both internal and external experts with respect to how climate solutions investments are identified globally.

Our key observations and considerations are as follows:

On the use of top-down fund classifications to account for climate solutions:

- Mercer was unable to identify a global framework threshold to support classifying a fund, in whole, as a "climate solution".

- The industry has not fully bridged the gap between fund labelling and accounting for climate solutions.

- The proposed practice of classifying 100% of an investment's notional share as a Climate Solution if >50% of revenue is derived from mitigation or adaptation activities could open CalPERS to greenwashing risks. In practice, the effect may be negligible.
- Global standards focus more clearly on identifying and labeling investments from the bottom-up, rather than at the top-down, or fund-level.
- We recognize, however, that CalPERS may find it useful to accurately communicate with stakeholders regarding investments that are intended to align with your overall climate strategy from a top-down perspective. Taking the foregoing considerations into account, we would suggest the following approach to facilitate communication while seeking to mitigate the risk of greenwashing, subject to CalPERS' preferences:
  - **At the fund level**, CalPERS could consider referring to "climate-related investments" to denote investments that are either committed or invested and are intended to include substantial exposure to climate solutions;
  - **At the security or portfolio level**, CalPERS could refer to "climate solutions" investments as a subset of climate-related investments that only includes invested capital, subject to specific definitions and in alignment with your Climate Solutions Taxonomy and Accounting Framework.

On CalPERS' bottom-up eligibility rules/taxonomy:

- Mercer would favor bottom-up accounting for climate solutions investments for external and Board reporting to reduce the risk of greenwashing accusations and promote a more defensible position.
- Bottom-up climate accounting for the Climate Transition Index and Private Market Fund would be more defensible against greenwashing accusations for CalPERS.
- CalPERS' asset-level taxonomies are generally reflective of global standards, including the Institutional Investor Group on Climate Change (IIGCC), European Union Sustainable Finance Disclosure Regulation (SFDR), and European Securities and Markets Authority (ESMA) for sustainable investing. Two observed deviations:
  – Strict "Do No Significant Harm" criteria are often employed by global frameworks.
  – IIGCC defines climate solutions in line with a 1.5° pathway to net zero.

On CalPERS' Climate Solutions Accounting Framework:

- CalPERS is contributing to the emerging industry practice of climate solutions accounting.
- IIGCC's Listed Markets Framework is among the most well-defined. CalPERS' climate solutions accounting framework largely follows the model set forth.

- A thorough accounting method for each asset class would enhance CalPERS’ climate solutions accounting framework and public defensibility. Some considerations:
  - Does CalPERS plan to aggregate committed or deployed capital? In private markets, assigning characteristics to unidentified investments is a key risk for greenwashing.
- CalPERS' current list of Real Estate Certifications includes generally accepted industry standards.
- With varied global industry standards for defining transition asset investing/accounting, CalPERS has likely narrowed the investable field with the focus on impact.
  - Mercer observes a potential risk of greenwashing, but also notes a lack of industry framework disallowing or cautioning against CalPERS’ transition asset accounting intentions.

Mercer has reviewed CalPERS' Climate Solutions Accounting Framework and compared it against prevailing global standards in what is still an emerging field in institutional investment. As noted above, while further development of the Framework will be required, particularly in private market asset classes, overall, based on Mercer's observations and considerations, CalPERS has taken a prudent and thoughtful approach to developing its Climate Solutions Accounting Framework, in line with leading global practices.

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