Financed emissions:

Closing the small business carbon data gap

Contents

Financial institutions are under pressure to make meaningful progress towards net zero pledges. But they can only improve what they can measure.

To meet their climate goals, lenders need accurate emissions data from their business customers. Yet most companies in their portfolios are small and medium-sized enterprises (SMEs) that are currently unable to provide this information.

As a result, lenders are relying on broad-brush sector-level estimates that fail to provide the deep insights that would enable them to take effective action.

In this e-book, we outline how this problem is hampering carbon reduction efforts and introduce Experian's solution: a detailed emissions profile for every single SME in the UK.

Experian ESG Insight gives lenders deeper, more nuanced insights on their business customers. Empowered to honour their climate pledges, they can sustain their value in the transition to a low-carbon world.

Setting financed emissions baselines: an urgent challenge for lenders

Most banks in the UK have publicly pledged to cut greenhouse gas (GHG) emissions to net zero by 2050, often with an interim target to halve emissions by 2030. Failing to honour these commitments could ultimately erode their stock price or threaten the wholesale funding upon which they depend.

But there's a problem. Commercial lenders don't have the data to accurately measure the emissions that represent more than 95% of their total carbon footprints – those generated by their business customers.

The challenge is that 99% of UK businesses are small or medium-sized enterprises (SMEs), many of which lack the resources to calculate their emissions. In the absence of precise data, lenders are forced to rely on blunt estimates that lump business customers together by sector. As a result, they are struggling to gain a clear view of their portfolios and pinpoint where they should focus their net-zero efforts.

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This lack of visibility of the 'financed emissions' associated with their lending activities is hampering their ability to:

- Set a robust baseline against which to measure progress towards net-zero goals
- Clear their portfolios of the most carbon-intensive businesses that are unable or unwilling to change
- Identify opportunities to dramatically cut emissions by helping existing or new customers decarbonise
- Differentiate between businesses by carbon intensity within broad sectors
- Measure and mitigate their exposure to climate-related risk

Intensifying stakeholder scrutiny

Pressure is mounting on lenders to simultaneously minimise their impact through credible net-zero pathways and increase their resilience to the impacts of climate change. Consumers are demanding businesses take greater responsibility. Investors want higher-quality sustainability data to inform their decision-making.

Regulators are only tightening the screw. The Prudential Regulation Authority is already insisting that lenders and insurers quantify and manage the climate-related financial risk related to both themselves and their customers.

Meanwhile, work by the International Sustainability Standards Board (ISSB) to set the first globally adopted baseline for sustainability disclosure standards has resulted in a new climate standard (IFRS S2). As a result, companies with commercial banking, insurance or asset management activities are required to disclose their financed emissions.

The UK government has thrown its weight behind the ISSB's standards and is building on them to develop its own Sustainability Disclosure Standards (SDSs). Due for government endorsement in July 2024, these are likely to form the basis of legal or regulatory requirements for UK businesses. Ultimately, financial institutions that are currently obliged to disclose their climate-related risks and opportunities in line with the recommendations of the Task Force for Climate-Related Financial Disclosures (TCFD) will have to refer to these tougher standards.

Peer pressure is growing too. Many banks have joined the Net-Zero Banking Alliance (NZBA), which commits them to align their portfolios with net-zero pathways by 2050, with annual reporting of their Scope 3 financed emissions and science-based targets for 2030 or sooner. Whether in or out of the NZBA, any lender seeking to get its net-zero targets validated by the globally recognised Science-Based Targets Initiative (SBTi) will need to disclose its financed emissions.

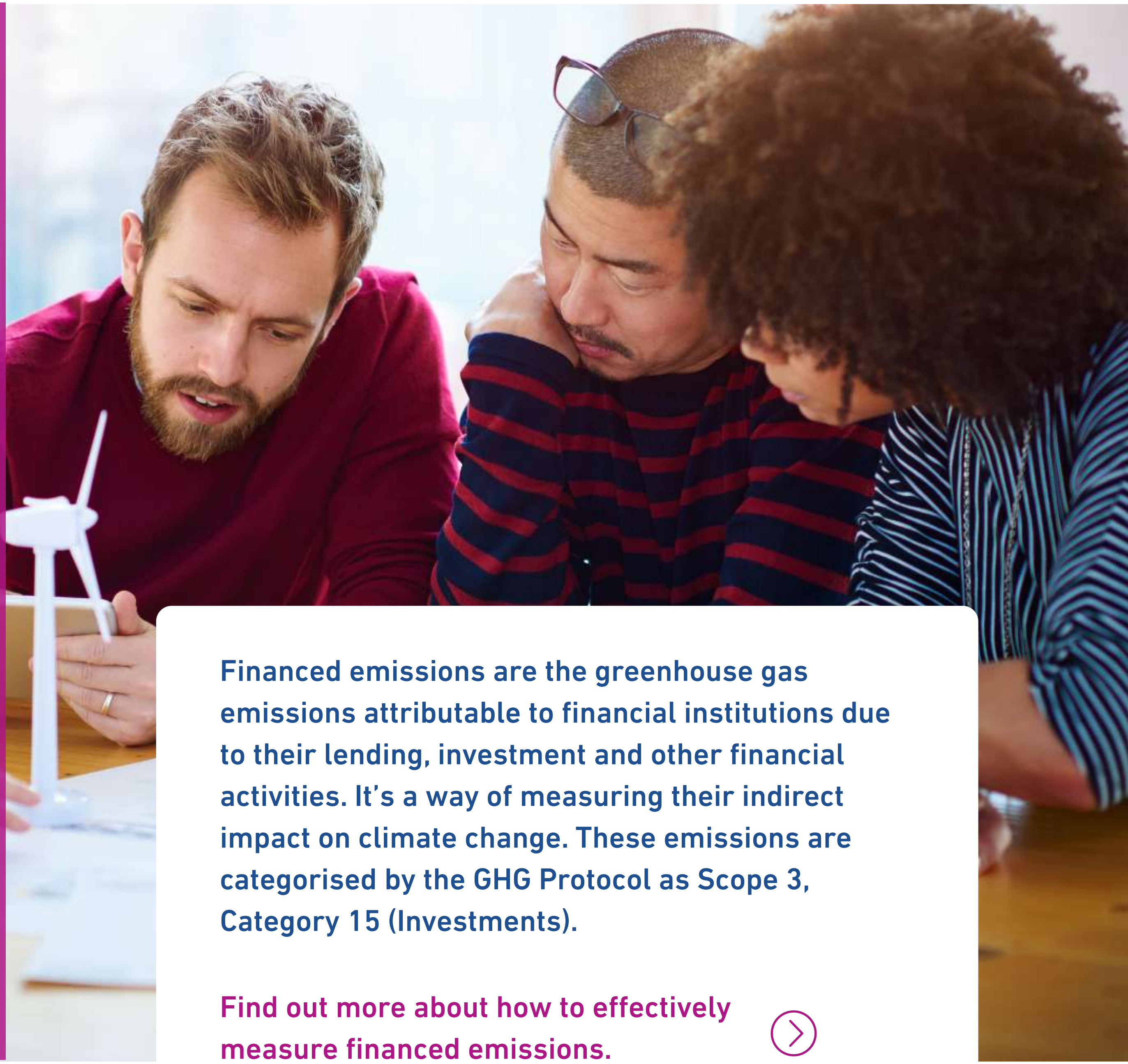
Our solution: Experian ESG Insight

At Experian, we have developed a simple tool to help lenders set credible financed emissions baselines.

Based on our trusted nationwide business data, Experian ESG Insight provides an instant emissions profile on every SME in the UK, enabling lenders to calculate their downstream customer emissions levels quickly and easily.

As well as giving them a reliable starting point upon which to track their progress towards net zero, the rich dataset helps lenders pinpoint carbon hotspots in their portfolios and the marketplace. This means they can target their decarbonisation efforts to the right business at the right time.

With greater visibility of their customers, they can also begin building climate-related risks and opportunities into their operational credit decisioning.



Financed emissions are the greenhouse gas emissions attributable to financial institutions due to their lending, investment and other financial activities. It's a way of measuring their indirect impact on climate change. These emissions are categorised by the GHG Protocol as Scope 3, Category 15 (Investments).

Find out more about how to effectively measure financed emissions.

Section 1:
Baseline blind spot:
SMEs

Carbon footprint calculation is probably not the top priority for the UK's small and medium-sized businesses. Individually, they are not big emitters. Microbusinesses, for example, each generate a tiny fraction of the GHG emissions of other SMEs. Why should these one-person bands, start-ups and close-knit family businesses with fewer than 10 employees dedicate precious resources to filling in questionnaires about their energy consumption and commuting habits?

Yet collectively SMEs pack a punch, generating 33% of the UK's GHG emissions and around 50% of business emissions. And because microbusinesses represent 95% of all UK businesses, they have a particularly large collective impact, with an emissions output almost as high as all other SMEs combined.

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Carbon culture clash

This status quo creates misaligned priorities. In the full glare of public scrutiny, the financial services industry is impatient to set financed emissions baselines. Lenders also want to know exactly which SMEs would benefit from decarbonisation support and which should be phased out of portfolios so they can advance towards net zero.

Meanwhile, the SME customers that form the bulk of lenders' portfolios – and the backbone of the UK economy – feel less urgency and stakeholder pressure. Research suggests that 87% of SMEs are unaware of their emissions and that only 3-11% have done work themselves to calculate their carbon footprint.[1]

Left in the dark, lenders are relying on vague estimates and proxies to set baselines that may have to change significantly when actual data eventually comes in, potentially damaging stakeholder trust. They are also struggling to target emission reduction strategies where they could have the most impact, curbing their progress.

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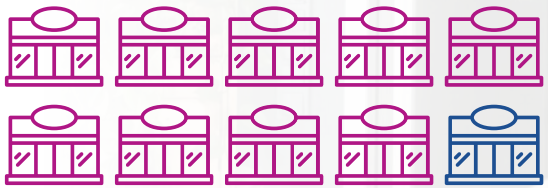

and that only 3-11% have done work themselves to calculate their carbon footprint.

[1]Natwest, British Business Bank, British Chambers of Commerce

Section 2: Baseline-setting methods: inadequate solutions

In an ideal world, lenders would have a live feed of energy and GHG data from their retail and commercial customers so they can identify emission-intensive hotspots in real time. It's an avenue that Experian is exploring, but we're not yet there.

These are the current market alternative methods being used to set baselines:

Manual collection from customers

When we first began asking lenders how they were calculating their financed emissions, many told us they were attempting to gather data directly from borrowers.

Some are still pursuing this method, using questionnaires, carbon accounting packages (either from a third party or self-built) or relationship manager-led surveys.

However, it's an onerous task that tends to reap low rewards. Lenders are unlikely to get responses from a high enough proportion of customers, leaving huge holes in their datasets. The quality of self-contributed data is variable and, in some cases, questionable. Worse, the process must be repeated every year, increasing the administrative burden for both lender and customer.

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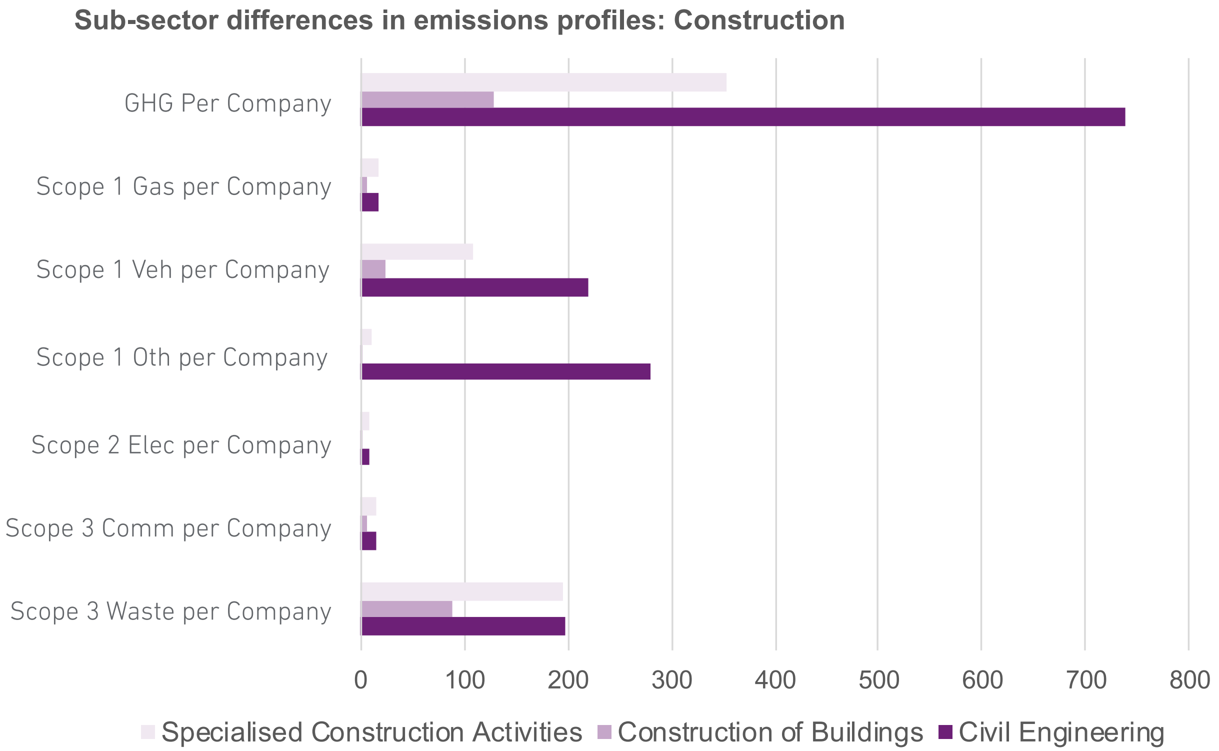
Macro sector-level modelling

Even where lenders are using guidelines provided by the Partnership for Carbon Accounting Financials (PCAF) to model financed emissions, nearly all are grappling with substantial data gaps. It's not just a lack of information on the businesses' activities but also an absence of financial data for determining the value of the business and its total debt. These are both essential factors impacting the attribution factor that determines the proportion of borrower emissions for which a lender is responsible.

To fill these gaps, lenders are reliant on sector averages that are too high-level to provide genuine insight. A sector-level view of SMEs will show total carbon emissions concentrated in manufacturing, agriculture, forestry and fishing, transportation and storage, as well as mining and quarrying. No surprises there. Yet lenders that devote all their attention to these sectors could miss big emitters hidden deeper in their portfolios.

Consider the graph below comparing SMEs trading in different sub-sectors of the construction industry. We looked at small firms with a revenue of £2-10m or a workforce of 10-49.



As you can see, civil engineering firms generate far higher emissions than firms engaged in housebuilding or specialist construction such as garden office builds.

This shows the value of more sophisticated datasets that dive deeper than sector averages to consider more illuminating attributes of an SME, such as its exact business activities, its geographical dispersion, distance from a commuting centre and fleet size.

These distinguishing features make all the difference. Take the example of a small independent bookshop in a city centre compared with a large frozen-food store in a remote market town. Both are high street retailers, yet their emission profiles should be radically different.

Our research shows that using sector proxies typically results in an over-estimation of SME emissions of nearly

200%

Equally, the approach could result in gross under-estimations that similarly distort a lender's financed emissions baseline. Inaccuracies could be hard to reconcile with actual data when it eventually becomes available, attracting accusations of greenwashing and stalling progress towards net zero goals.

Section 3:
Creative strategies rely on richer insight

With only a hazy, high-level overview of their customers' emissions, lenders can only make sweeping decisions such as eliminating whole sectors or sub-sectors from their portfolios. It's neither a viable nor a palatable option for most lenders – or indeed for the UK economy.

With deeper insights, however, ESG leads could zero in on carbon-heavy SMEs and deploy creative strategies to reduce financed emissions.

Strategy 1

One strategy would be to focus their engagement efforts on customers with a 'carbon problem', offering advice on the benefits of decarbonisation and practical support to measure and reduce emissions.

Strategy 2

Another tactic could be to develop sustainability-linked loans for SMEs that are scaled in accordance with specific criteria. These would need to be backed by assured data to ensure the loans resulted in genuine positive impact and didn't attract accusations of greenwashing.

Strategy 3

A third approach would be for lenders to phase out high emitters that can't easily decarbonise while bringing carbon-heavy businesses with a propensity for change into their portfolios. These could be businesses with a high degree of optionality – to electrify machinery, for example, switch to more sustainable suppliers or create innovative low-carbon products. Ideally, they would also be businesses that are already passionate about transitioning to a low-carbon economy and won't have to radically change their business models.

Challenger lenders, as relative newcomers to the financial services industry, will typically find it easier to attract these agile and progressive businesses. A high concentration of them can be found in retail and the accommodation and food services sector, and they tend to be smaller and younger than tier one customers. Despite their relative adaptability, they may be more anxious about, and less cushioned from, the financial risks associated with the transition to a low-carbon economy.

Tier one banks instead need to focus on the larger companies with which they have developed long-term relationships. Close to 80% of emissions in tier one lenders' portfolios originate in companies that are more than 10 years old, with the highest concentrations in manufacturing, agriculture and transport. These larger, well-established players may have more resources to dedicate to sustainability programmes, but they may also need more support with the heavy lift of modernising their business models, machinery and ways of working.

Linking carbon and credit risk

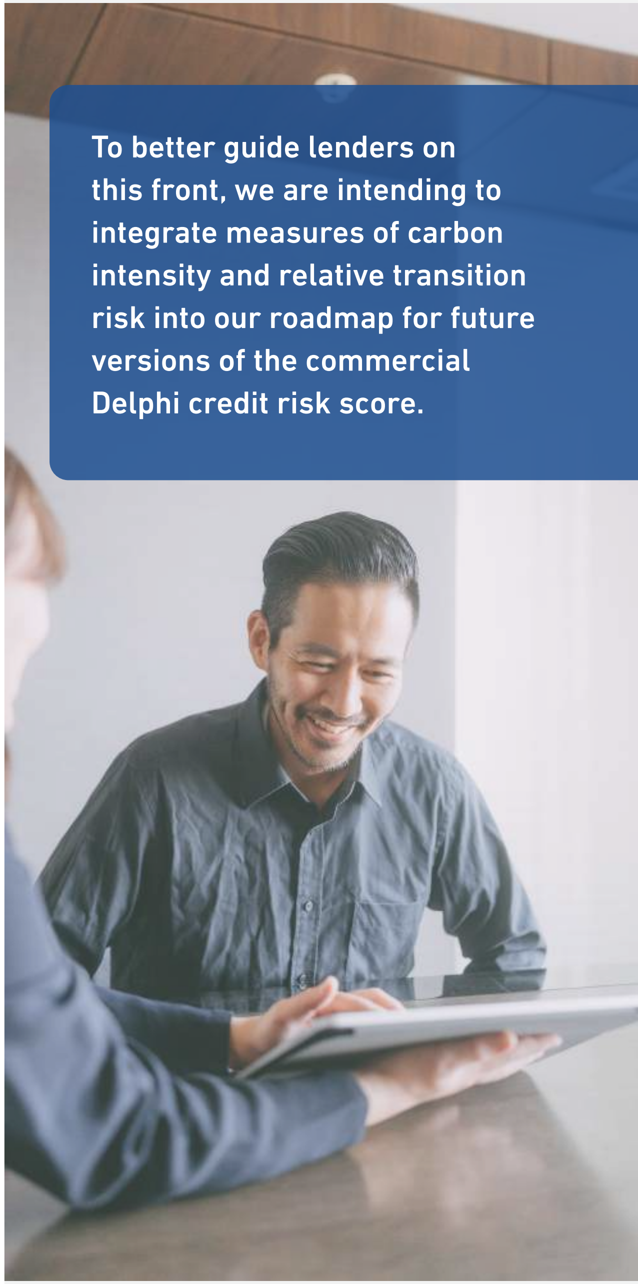
Perversely, our data shows that the higher an SME's emissions are, the lower its credit risk score is. At first this makes carbon-heavy companies appear to be a safer bet for lenders. But that's a red herring. The correlation simply reflects the size of the company: larger businesses tend to be more established and therefore deemed less risky despite their bigger carbon footprints. In fact, 74% of SME emissions lie in companies that have a below average credit risk profile.

When we take business size out of the equation and look at carbon intensity – grammes of CO2e produced per £1 of revenue – the results are reversed. Generally, the more carbon-intensive an SME is, the riskier it is. This is likely due to its exposure to energy price volatility and growing regulatory scrutiny as well as rising consumer demand for sustainable products and services.

Interestingly, there is a correlation between the size of an SME's workforce and its carbon intensity, with companies of 50-100 employees typically being the least carbon-intense. This appears to be a sweet spot where the benefits of economies of scale intersect with compactness and simplicity. In other words, these businesses are unlikely to have multiple sites or be involved in complex and heavy industry.

To reduce financed emissions while mitigating credit risk, lenders will need to seek out customers with relatively low carbon intensity across all sizes and sectors. However, one surprising finding from our research is that the opposite is currently happening. Since 2019, the carbon intensity of the average SME borrower has been growing steadily. This trend is counterproductive to reducing financed emissions, and we suspect it's a reflection of how higher energy-reliant businesses have felt more of the pain from dramatically rising energy costs.

To better guide lenders on this front, we are intending to integrate measures of carbon intensity and relative transition risk into our roadmap for future versions of the commercial Delphi credit risk score.



Section 4: Introducing Experian ESG Insight

As the UK's most recognised provider of credit information, Experian has an unparalleled wealth of data on the UK's five million SMEs.

Leveraging this vast resource, we have developed **Experian ESG Insight**, a pragmatic new tool to give lenders a more accurate view of their financed emissions – instantly and easily.

Experian ESG Insight is a rich dataset that provides an ESG and GHG profile on every SME in the UK, both limited and non-limited. This includes an emissions estimate broken down into Scope 1, 2 and 3 emissions.

The tool also provides insight on the governance practices and social impact of individual businesses, allowing for ESG segmentation.

Instead of relying on blunt sector-level proxies, Experian ESG Insight applies a logic-based algorithm to 11 key data attributes to arrive at an individually tailored emissions estimate for each SME. Lenders get a detailed and nuanced view of the borrowers in their portfolios that considers:

ESG Insight attributes

- Detailed 'real-world' business activity derived from advertised services (not just Companies House declared sector)
- Number of sites and regional location
- Number of employees
- Rurality / proximity to a commuter hub
- Corporate Group linkage
- Fleet size
- Social factors including board diversity
- Governance factors including credit score
- Company financials
- Debt

Linking carbon and credit risk

Not only does Experian ESG Insight make life easier for lenders but crucially it requires no input from SMEs. As leading providers of trusted business intelligence, we already have the data that matters.

It means lenders have a sound foundation on which to build their net zero programmes coupled with the ability to identify the portfolio hotspots where their work can be most impactful.

Supported by a wider set of SME attributes from our BusinessView database, the tool can also be used for climate risk assessment – the next major priority for financial institutions.

Experian ESG Insight is built on Experian BusinessView, our industry leading database of over five million UK companies, containing hundreds of variables and attributes.

Other inputs include SME financials, open government data, plus macro-statistical data from BEIS, DEFRA, DVSA, HMRC, SMMT and the ONS.

Contributing governance and social attributes include:

1. Board gender diversity
2. Unsatisfied CCJs
3. Prompt invoice payments, accounts filing
4. Evidence of net-zero and Modern Slavery policies
5. Regulated and charitable status
6. Relative 'generosity' to employees

Experian ESG Insight is refreshed quarterly and is available via an API or as a batch enhancement.

Benefits

Report on SME portfolio emissions and calculate financed emissions with a stable, repeatable, robust methodology

Redefine policy rules to hit financed emissions targets and ESG goals, and minimise climate-related risk while minimising revenue impact

Benchmark portfolios on ESG factors and emissions; by product, brand, over time, and against the full UK SME population

Use insight to drive development of new products for SMEs that reduce their and your emissions footprint

Target individual SMEs with green finance needs

Model the impact of sustainability-linked loans

Target engagement with customers on sustainability and social impact issues

Lay the foundations for assessing and manage climate-related risks and opportunities

Section 5: Futureproofing financed emissions

The field of GHG emissions data is evolving fast. While providing an actionable solution today, Experian ESG Insight is primed to take advantage of new developments, ensuring lenders continue to enjoy the highest possible visibility of SME emissions.

We have an evolving roadmap of improvement planned for our emissions model, committing us to stay ahead of market expectations as new assured data sources become available and the number of SMEs measuring their emissions increases.

Open energy

The UK government has been working with Bankers for Net Zero and a range of industry stakeholders to automate SME sustainability reporting on a national scale through an 'open energy' approach. This would provide a simple consented journey for property occupants and owners (including SMEs) to provide their lender or insurer access to assured energy consumption readings transformed into scope 1 and 2 emissions equivalents.

It's a truly exciting move that could remove much of the need for estimates. We will be fully embracing this new data capability as it comes online in the coming years.

A central ESG registry?

We are observing a need for a market-wide utility to act as a central registry of SME ESG profiles. Credit reference agencies such as Experian have been mentioned as a potential conduit for SME data in a recent [Banker for Net Zero market report.](#)

Certainly, if the market continues as it is, SMEs could end up having to use a different ESG profiling tool for each bank, insurer or supplier – each with its own measurement methodology and degree of data quality.

A single unified register that brings together ESG profile data from multiple carbon accounting platforms and survey tools to give full coverage of the SME population seems the way forward. It would lessen the paperwork for SME owners and provide a raised common data backdrop for lenders and other data users.

This could also provide ESG attribute data that could feed into an ESG-factored version of a business credit score.

Future fit

To limit global warming to 1.5°C above pre-industrial levels as demanded in the landmark Paris Agreement, all sections of society will need to work together to achieve net zero emissions by 2050. The financial services industry will play a leading role in this transition by choosing its customers wisely and supporting their decarbonisation.

Critical to this mission is high-quality data on financed emissions. Experian ESG Insight provides a simple solution that will only improve over time, helping lenders set credible baselines today and meet their climate goals tomorrow.

For further information or to understand more about how ESG Insight can help your business, contact us at businessuk@experian.com.

Further reading

- 6 CONSIDERATIONS ON INTEGRATING CLIMATE RISK INTO LENDERS' CREDIT RISK MANAGEMENT
- WHAT ARE FINANCED EMISSIONS AND HOW TO EFFECTIVELY MEASURE THEM?
- WHAT ARE CLIMATE AND ESG RISKS AND HOW CAN LENDERS AND INSURERS REDUCE THEM?
- 5 SOLUTIONS TO THE ESG DATA GAP FOR SMES

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