Greenhouse Gas accounting for the financial industry

Summary of the Draft Standard of the Partnership for Carbon Accounting Financials

Minds made for transforming financial services

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Minds made for building financial services

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Achieving a net zero ambition: a case for carbon accounting

Climate change is now recognized as presenting significant risks to the global economy, with impacts that are complex, varied and hard to measure across different sectors and regions. Limiting global temperatures to well below 2 degrees Celsius, in line with the Paris Agreement, is a challenge that requires urgent and sustained action from all sectors, including the financial sector.

In response to this, a number of climate change initiatives across the financial sector have rapidly emerged to tackle the risks associated with climate change. This includes the UK Prudential Regulation Authority (PRA) requirement to conduct climate change scenario analysis, as well as the Taskforce on Climate-related Financial Disclosures (TCFD).

The Partnership for Carbon Accounting Financials (PCAF) is the primary industry-led initiative that seeks to provide a comprehensive standard for carbon accounting in the financial sector. Set up in 2015 by a coalition of Dutch banks, it released a draft of its first globally harmonized standard in August 2020, which is open for public consultation until September 2020. The final release is planned for November 2020.

Carbon accounting: the basics

The dominant and globally accepted standard for carbon accounting is the GHG Protocol Corporate Accounting and Reporting Standard (‘GHG Protocol’), issued by the World Resources Institute (WRI) and the World Business Council for Sustainable Development (WBCSD). This divides the emissions into three broad categories, or “scopes”:

<table>
<thead>
<tr>
<th>Scope</th>
<th>Examples for a financial institution</th>
</tr>
</thead>
<tbody>
<tr>
<td>Scope 1: Direct Greenhouse Gas (GHG) emissions from sources that are owned or controlled by the company</td>
<td>Combustion in entity-owned vehicles</td>
</tr>
<tr>
<td>Scope 2: Indirect GHG emissions from the generation of purchased energy</td>
<td>Purchased electricity in offices</td>
</tr>
<tr>
<td>Scope 3: All others indirect GHG emissions</td>
<td>Air travel; work-from-home emissions; emissions from investments and loans</td>
</tr>
</tbody>
</table>

For those in the financial services industry, it is very likely that the most material emissions will come from scope 3 emissions, and in particular those arising from their investments and loans.

While the GHG protocol does recognize that these emissions should be accounted for, it does not provide detailed guidance on how to consistently do this. The standard developed by PCAF seeks to address this gap.

The PCAF standard builds on the GHG protocol, and is based on the concept that investors and lenders report on a proportion of the carbon emissions from each of its counterparties (e.g., a borrower, investee company, financed asset or otherwise.).

What are the business goals of carbon accounting?

• Align financial flows to the Paris Agreement
• Create transparency for stakeholders
• Manage climate-related financial risks

“Follow the money”: measuring financed emissions

We have distilled the measurement of financing emissions into the following high-level five-step approach:

1. **Determine the asset class**

   The approach to carbon accounting is determined by the asset class based on the type of financing. At present, the standard covers a total of six asset classes (listed overleaf), which covers listed and non-listed corporate finance, project finance (which can also be applied to private equity) and consumer loans.

2. **Assess greenhouse gas data availability**

   The standard recommends that accounting should use primary GHG data (e.g., directly collected from the counterparty or asset) as much as possible. There are various routes to obtaining GHG data, which include directly from the investee or counterparty (e.g., in annual reports), as well as through external data vendors (such as CDP or Bloomberg).

3. **Build estimation models or proxies**

   If primary data is not available, emissions should be estimated either by using activity data or proxies such as industry averages. How to make estimations or use proxies will depend on various factors, including asset class, sector and region.

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### Example for business loans asset class: estimation by using proxies

While a wide variety of methods exist to estimate emissions, the example below illustrates how the average emission intensity for agricultural assets in the United Kingdom could be used as a proxy to estimate emissions from a UK company in the same sector.

<table>
<thead>
<tr>
<th>Calculation</th>
<th>Total emissions by the UK agricultural sector</th>
<th>Total assets of the UK agricultural sector</th>
<th>Total balance sheet value of a counterparty in the agricultural sector</th>
<th>Estimated emissions from counterparty</th>
</tr>
</thead>
<tbody>
<tr>
<td>Data source</td>
<td><a href="example.com">Committee on Climate Change</a></td>
<td><a href="example.com">Office for National Statistics</a></td>
<td><a href="example.com">Bank systems</a></td>
<td></td>
</tr>
</tbody>
</table>

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### Asset classes currently covered by the standard

- Listed equity and bonds
- Business loans
- Project finance
- Commercial real estate
- Mortgages (residential)
- Motor vehicle loans

### Addressing data gaps

Data limitations should not prevent financial institutions from calculating their financed emissions, as the PCAF standard allows a number of estimation methods to be applied if data is not available.

For most asset classes this is divided into two groups:

1. Based on physical activity: such as production (e.g., Barrels of Oil Equivalent) or energy consumption (KwH), which can be multiplied by a standard emission factor (e.g., those published by UK Department for Environment, Food and Rural Affairs (DEFRA)).

2. Based on economic activity: such as revenues (in USD, GBP, EUR, etc.), which can be multiplied by a region or sector-specific Environmentally extended input-output (EEIO) emission factor. Various institutions provide these factors, including Global Trade Analysis Project (GTAP) and EXIOPBASE, or they can be calculated.
4. Calculate the attribution factor

The attribution factor is the proportion of the total emissions that the lender or investor should recognize. How the attribution factor is calculated depends on the asset class, but as a general rule this is the value of the investment or loan, divided by the total value of the asset or counterparty. For some asset classes, such as mortgages, the standard recommends always recognizing 100% of the emissions.

<table>
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<th>Example for business loans asset class: calculating the attribution factor</th>
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<td>The attribution factor for business loans is calculated by dividing the outstanding amount at a given timepoint (e.g., year-end), by the enterprise value (preferably including cash.)</td>
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</table>

5. Calculate financed emissions

The final step is to calculate the financed emissions by multiplying the attribution factor by the total emissions data. This should be repeated for each investment or loan, after which they should be summed up to arrive at a total financed emissions number for the financial institution.

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Data quality scores

GHG data quality varies widely and in some cases may not be available. To provide transparency over the quality of the data, the standard recommends disclosures on data scores. It distinguishes five scores: A data score of 1 is the most preferred, which relates to actual audited data. Score 5 is the least preferred, which relates to estimated data with limited support. This system enables reporting on financed emissions even if data is not available, whilst providing transparency over the accuracy of the information provided.

<table>
<thead>
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<th>Certain (5%-10% error margin in estimations)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Score 1</td>
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<tr>
<td>Score 2</td>
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<tr>
<td>Score 3</td>
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<tr>
<td>Score 4</td>
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<tr>
<td>Score 5</td>
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</table>

Next steps

The public consultation for the standard closes on 30 September 2020 and the final version is expected in November 2020.

With a number of international financial institutions already committing to the standard as well as an industry drive toward setting zero-carbon ambitions, there is an expectation that the standard will gain further traction in the near term.

Financial services organizations should act now by:

- Forming a view on how financed emissions may inform other climate-initiatives, including stress-testing and zero-carbon ambitions
- Assessing the adequacy of existing data, supporting data infrastructure and reporting capabilities
- Understanding what implications this standard will have on existing carbon and climate change disclosures

How EY can help

The multidisciplinary sustainable EY finance teams that combine risk, policy, finance and climate change knowledge are well placed to help you navigate the climate action and disclosure agenda. We can help your organization understand the applicable requirements, design and assess your processes and review the accuracy and completeness of data. We are ready to help you evaluate your climate-related risks and opportunities and support actions to improve performance.

At EY we believe that the financial services sector has a central role to play in delivering a future that gets us to a well below two degrees climate scenario. As a leading professional services firm, we encourage our clients to report transparently on their carbon emissions to demonstrate their commitment to a net zero future. The proposed PCAF standard provides a much needed methodology to consistently and transparently do this.
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