ISSUE BRIEF

Bankrolling Carbon: How to Measure Financed Emission

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When investors try to analyze emissions from their investments, nothing is more vexing than accurately gauging Scope 3 Emissions: those emissions that result from activities not owned or controlled by the company. In the world of Scope 3 emissions, nothing is more vexing than "financed emissions." The capital markets just rely so heavily on the activities causing the emissions that their scale is enormous.

Financed Emissions

Financed emissions are the greenhouse gas (GHG) emissions that are generated as a result of the services, investments, and lending activities of financial institutions. This typically would include underwriting of equities and bonds, business loans, project financing, commercial real estate mortgages, and motor vehicle loans that financial institutions have on their books. They are essentially the carbon footprint of a financial institution's loans and investments. Financed emissions comprise the bulk of a financial institution's Scope 3 emissions—those that occur upstream and downstream in the value chain. The larger the bank, the more lending and banking activity. The more lending and banking activity, the larger the pool of financed emissions.

Collection and Reporting of Emissions Data

Measuring and managing financed emissions is crucial for financial institutions to understand and reduce their overall climate impact, as these emissions are usually significantly larger than

the institution's direct operational emissions. CDP found that, of the financial institutions that disclose climate data through CDP, financed emissions are, on average, 750x larger than reported operational emissions. Interestingly, this figure varies significantly across regions, from 250x in Europe to 270x in the Asia-Pacific region, to 11,000x in North America. [1]

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Reporting on financed emissions is still in its early stages. Most reporting is voluntary and lacking in quality. Many crucial sectors and asset classes are frequently omitted from assessments, while transparency regarding methodologies, assumptions, and data quality remains scarce. This is partly because accounting for financed emissions is extremely difficult. The nature of financed emissions requires a company to rely on data collected from its downstream partners, i.e., the companies in which it lends and invests.

However, many companies aren't yet collecting complete emissions data. Further, building robust financed emissions accounting requires substantial resources—staffing, data infrastructure, tools, etc. The lack of regulatory requirements and standards also hinders the reporting process. In the United States, the Securities and Exchange Commission last year proposed a rule requiring companies to report on Scope 1, 2, and 3 emissions. Yet, the final ruling was watered down and excluded the Scope 3 requirement. Still, financed emissions are becoming increasingly important to regulators, investors, and the public as financial institutions work to align their activities with global climate goals.

Disclosure Standards

To date, the Global GHG Accounting and Reporting Standard developed by the Partnership for Carbon Accounting Financials (PCAF) is the leading framework used for financed emissions disclosures. Currently, PCAF has over 470 members across the globe. According to CDP, one of the most widely utilized broad climate disclosure frameworks, 39% of financial institutions that reported through CDP in 2022 disclosed a figure for their absolute financed emissions, and 79% of financial institutions that disclosed financed emissions through CDP referenced PCAF and/or PCAF's Global GHG Accounting and Reporting Standard as their chosen methodology for calculating financed emissions. [2]

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The purpose of the PCAF Standard [3] is to provide financial institutions with guidelines for measuring and reporting financed emissions that are clear, consistent, reliable, and comparable. The Standard is made up of three parts covering financed emissions, facilitated emissions, and insurance-emissions, respectively. It provides detailed methodologies for measuring financed emissions across seven key asset classes: listed equity and corporate bonds, business loans and unlisted equity, project finance, commercial real estate, mortgages, motor vehicle loans, and sovereign debt. It also provides guidance on removing, or carbon offsets, in some of these asset classes. Importantly, PCAF includes a data quality scoring system on a 1-5 scale that allows financial institutions to transparently communicate the reliability of the emissions data used in their financed emissions calculations. The hope is that, over time, the quality of reported data will continue to improve, and more institutions and regulatory bodies will adopt frameworks similar to the PCAF Standard.

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[1,2] CDP Financial Services Disclosure Report 2022 - CDP

[3] Enabling financial institutions to assess and disclose greenhouse gas emissions associated with financial activities